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Discrimination Against Unwed Mothers as Prohibited Sex Discrimination Under Title VII and the Constitution

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> *It is true that many women are unmarried and not affected by any of the duties, complications, and incapacities arising out of the married state, but these are exceptions to the general rule. The paramount destiny and mission of woman are to fulfil the noble and benign offices of wife and mother.*[1]

I. Introduction

The role of the American woman in employment has changed radically since the United States Supreme Court upheld a decision by the Illinois Supreme Court denying Myra Bradwell's application for a license to practice law solely because she was a female.[2] In 1976, adult women accounted for more than one-half of the total employment gain in the United States, and today they comprise over one-third of the labor force.[3] The change in the composition of the labor force can be attributed to a number of economic, sociological, psychological, and legal factors. Undoubtably, the mechanization of the home has greatly reduced the need for women to concentrate their energies managing a household. In addition, industrialization has made more jobs available, primarily in the service category (traditionally containing a high percentage of females), and has brought additional jobs within the capacity of women, in terms of both physical competency and personal desirability. Changing attitudes within society concerning the role of females in the labor force has also contributed (although perhaps gradually) to higher work-force participation rates of women.

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[1]Bradwell v. Illinois, 83 U.S. (16 Wall.) 130, 141 (1872) (Bradley, J., concurring).

[2]*Id., aff'g In re* Bradwell, 55 Ill. 535 (1869).

[3]Bednarzik & St. Marie, *Employment and Unemployment in 1976*, 100 Monthly Lab. Rev., Feb. 1977, at 4.

Arguably, the existence of state and federal legislation offering relief to females who are the object of discriminatory employment practices has increased the participation of women in the labor force.[4] Although state labor laws affecting the employment rights of women were traditionally of a "protective" nature (*i.e.*, minimum hours and limitations on weight lifting), forty states have enacted some form of fair employment legislation prohibiting sex discrimination in employment as of this writing. An additional six states have enacted equal pay legislation. Not surprisingly, current state as well as federal legislation has displaced many of the traditional protective statutes, resulting in only a handful of operative protective acts.[5] Federal legislation designed to alleviate sexually discriminatory employment practices includes Title VII of the Civil Rights Act of 1964[6] and the Equal Pay Act of 1963.[7] In addition, section 1983 of the Civil Rights Act of 1871[8] has been held to be applicable to claims of

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[4]*See* text accompanying note 2 *supra*. It is noteworthy that with the increase in the number and percentage of women in the labor force, women as a class are still employed in low-paying, traditionally female occupations. For example, in 1975 females accounted for 97% of all registered nurses, 85.4% of all elementary school teachers, 96.6% of typists, and 91.1% of all waiters and waitresses. L. Howe, Pink Collar Workers 21 (1977). In addition, women's median earnings for full-time work in 1957 were $3,000, while men earned $4,750. By 1973, the disparity was even greater with women's earnings at $6,500 and men's at $11,500. Moreover, recent data indicate that during periods of unemployment women as a class traditionally experience higher rates of unemployment than men. Thus, in 1975, the average unemployment rate for women was 9.3% of the labor force, as compared to 7.9% for men. Furthermore, studies show that once they are unemployed, women are less likely to end a spell of unemployment by finding a job than their male counterparts. Approximately two-thirds of the men seeking jobs end their spells of unemployment by finding jobs while somewhat less than half of all women seeking jobs become employed. Garfinkle, *The Outcome of a Spell of Unemployment*, 100 Monthly Lab. Rev., Jan. 1977, at 54.

[5]8A Lab. Rel. Rep. (BNA) 451:151-154 (1977).

[6]42 U.S.C. §§ 2000e to 2000e-17 (1970 & Supp. V 1975). *See* note 12 *infra* and accompanying text.

[7]29 U.S.C. § 206(d) (1970). This act makes it unlawful for an employer covered under the statute to pay wages "at a rate less than the rate at which he pays wages to employees of the opposite sex . . . for equal work on jobs the performance of which requires equal skill, effort, and responsiblity, and which are performed under similar working conditions." *Id.* § 206(d)(1). The Equal Pay Act only focuses on wage differentials based on sex. Differentials based on race, color, religion, and national origin, although prohibited by Title VII, are not subject to claims under the Equal Pay Act. Coverage of the Act is restricted to those employers subject to the minimum wage provisions of the Fair Labor Standards Act of 1938. *Id.* § 206(a) (incorporating minimum wage provisions of the Fair Labor Standards Act of 1938, 29 U.S.C. §§ 201-219 (1970 & Supp. V 1975)).

[8]42 U.S.C. § 1983 (1970) provides:

> Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisidction thereof to

sex discrimination.[9]

Clearly the paramount destiny and mission of women is no longer considered to be that of "wife and mother" by the legislatures or the courts. However, this is not to assert that women, many of whom are wives and mothers, are free of employment discrimination. Indeed, a problem being encountered by an increasing number of the female labor force concerns the employment status of a woman once she has voluntarily or involuntarily become an unwed mother.[10] Recent case law demonstrates that employers in both the private and public sector have engaged in various forms of discrimination against women who have fostered children out of wedlock.[11] This Article will examine the potential remedies provided by Title VII and the Constitution for women who have experienced employment discrimination because of their status as unwed mothers. Part I will focus on Title VII. After reviewing the structure of the statute, the analysis will focus on the theories of employment discrimination generally available to females claiming discrimination based on their unwed parent status. The defenses available to the employer under the statute will also be considered. Part II will focus primarily on a due process and equal protection analysis under the Constitution. The traditional and current standards of review

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the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

[9]*See, e.g.*, Cohen v. Illinois Inst. of Technology, 524 F.2d 818 (7th Cir. 1975); Dombrowski v. Dowling, 459 F.2d 190 (7th Cir. 1972) (state action required for cause of action under § 1983); League of Academic Women v. Regents of the Univ. of Cal., 343 F. Supp. 636 (N.D. Cal. 1972). *See also* Jubilee Mfg. Co., 202 N.L.R.B. 272 (1973); Labor Management Relations Act, 29 U.S.C. §§ 141-197 (1970 & Supp. V 1975) (this Act may, under limited circumstances, provide a remedy for sex discrimination); Exec. Order No. 11,246, 3 C.F.R. 339 (1964-65 Compilation), *as amended by* Exec. Order No. 11,375, 3 C.F.R. 684 (1966-70 Compilation) (sex discrimination by federal contractors prohibited).

[10]In 1975, there were approximately 450,000 illegitimate births in the United States, compared to approximately 407,000 in 1973. Yager, *Out of Wedlock*, Wall St. J., Sept. 12, 1977, at 1, col. 1. *See* 1 U.S. Dept. of Health, Education, & Welfare, Vital Statistics of the United States at 1-29 (1973).

[11]Discrimination against pregnant employees has generally been manifested in four areas: Hiring, fringe benefits, forced termination, and the right to a maternity leave of absence. *See* Note, *Title VII and the Pregnant Employee*, 49 Notre Dame Law. 568 (1974). These traditional forms of discrimination are especially prevalent against unmarried pregnant females. *See* Jacobs v. Martin Sweets Co., 550 F.2d 364 (6th Cir. 1977) (constructive discharge); Andrews v. Drew Mun. Separate School Dist., 371 F. Supp. 27 (N.D. Miss. 1973), *aff'd*, 507 F.2d 611 (5th Cir. 1975) (failure to hire, discharge); Leechburg Area School Dist. v. Pennsylvania Human Relations Comm'n, 19 Pa. Commw. Ct. 614, 339 A.2d 850 (1975) (denial of maternity leave); Wardlaw v. Davidson, 10 Fair Empl. Prac. Cas. 891 (Tex. Dist. Ct. 1975) (transfer to non-classroom position).

applied by the Supreme Court in sex discrimination cases will be considered, followed by a comparison of sex discrimination criteria under the Constitution and Title VII with special emphasis on the case of the unwed parent.

II. Employment Discrimination Against Unwed Mothers as Prohibited Discrimination Under Title VII

A. *Background*

Title VII of the Civil Rights Act of 1964, as amended in 1972,[12] explicitly prohibits employment discrimination in hiring, firing, compensation, terms, conditions, or privileges of employment on the basis of race, color, religion, sex, or national origin. Since 1972, the Act has applied to employers engaged in an industry affecting commerce who have fifteen or more employees for each working day in each of twenty or more calendar weeks in the current or preceeding calendar year.[13] It also applies to employment agencies procuring employees for such an employer[14] and to most labor organizations.[15] The 1972 amendments also extended coverage to all state and local governments, government agencies, political subdivisions (except for elected officials, their personal assistants,

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[12]Civil Rights Act of 1964 §§ 701-718, 42 U.S.C. §§ 2000e to 2000e-17 (1970 & Supp. V 1975). *Id.* § 2000e-2(a) to (c) provides in part:

> (a) Employer practices.
>
> It shall be an unlawful employment practice for an employer—
>
> (1) to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual . . . because of such individual's race, color, religion, sex or national origin; or
>
> (2) to limit, segregate, or classify his employees . . . in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individual's race, color, religion, sex, or national origin.
>
> . . . .
>
> (c) Labor organization practices.
>
> It shall be an unlawful employment practice for a labor organization—
>
> (1) to exclude or to expel from its membership, or otherwise to discriminate against, any individual because of his race, color, religion, sex, or national origin;
>
> (2) to limit, segregate, or classify its membership . . . in any way which would deprive or tend to deprive any individual of employment opportunities, or . . . otherwise adversely affect his status as an employee . . . because of such individual's race, color, religion, sex, or national origin; or
>
> (3) to cause or attempt to cause an employer to discriminate against an individual in violation of this section.

[13]*Id.* § 2000e(b) (Supp. V 1975).

[14]*Id.* §§ 2000e(c), 2000e-2(b) (1970 & Supp. V 1975).

[15]*Id.* § 2000e-2(c) (Supp. V 1975).

and immediate advisors), and the District of Columbia department and agencies (except where subject by law to the federal competitive service).[16]

Any person claiming to be aggrieved under the statute may file a complaint with the Equal Employment Opportunity Commission (EEOC). The EEOC is vested with the authority to investigate individual charges of discrimination, to promote voluntary compliance with the statute, and to institute civil actions against parties named in a discrimination charge.[17] The Commission cannot adjudicate claims or impose administrative sanctions. Rather, the statutory scheme designates the federal courts as the main enforcement agency and authorizes the courts to issue injunctive relief and to order such affirmative action as may be appropriate.[18]

Under Title VII, discrimination based on religion, sex, or national origin is regulated by a statutory standard differing from that applied to race or color. Employment discrimination with respect to religion, sex, or national origin is permitted where religion, sex, or national origin is a bona fide occupational qualification (BFOQ) reasonably necessary to the normal operation of a particular business.[19] Accordingly, the statute mandates a two-step analysis in employment discrimination cases. First, the court must find that the employer has engaged in discrimination under one of the prohibited classifications as outlined in the statute. Only after the court has made a determination that a prohibited form of discrimination has occurred will the court consider step two,

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[16] *Id.* §§ 2000e(a), (f), 2000e-16.

[17] *Id.* §§ 2000e-5, 2000e-6(e).

[18] *Id.* § 2000e-5(f), (g).

[19] *Id.* § 2000e-2(e) provides:

> Notwithstanding any other provision of [the Act], (1) it shall not be an unlawful employment practice for an employer to hire and employ employees, for an employment agency to classify, or refer for employment any individual, for a labor organization to classify its membership or to classify or refer for employment any individual, or for an employer, labor organization, or joint labor-management committee controlling apprenticeship or other training or retraining programs to admit or employ an individual in any such program, on the basis of his religion, sex, or national origin in those certain instances where religion, sex, or national origin is a bona fide occupational qualification reasonably necessary to the normal operation of that particular business or enterprise . . . .

It is noteworthy that this section does not permit a BFOQ exception with respect to "race," and the legislative history of Title VII indicates that the exclusion was intentional. *See* U.S. Equal Employment Opportunity Commission, Legislative History of Title VII and Title XI of the Civil Rights Act of 1964 at 3183-85, 3191-92 (1968); H.R. Rep. No. 914 & S. Rep. No. 872, 88th Cong., 2d Sess., *reprinted in* [1964] U.S. Code Cong. & Ad. News 2355.

wherein the employer has the option to demonstrate that the discrimination was justified as a BFOQ.[20]

B. Theories of Sex Discrimination

Title VII was drafted primarily to deal with discrimination based on race, national origin, and religion. The amendment adding "sex" as a prohibited employment criterion was passed one day before the House of Representatives approved Title VII. It was inserted in the 1964 Act on the floor of the House by Representative Howard Smith of Virginia who stated that he wanted to prevent discrimination against the "minority sex."[21] Congressman Smith had actually opposed the passage of Title VII and was accused by some of wishing to sabotage its passage by his inclusion of the sex-based amendment.[22] In any event, little legislative history exists to aid the courts in interpreting the meaning and scope of such a complex and evasive phenomenon as sex-based discrimination.[23] Moreover, the statute itself does not define "discrimination."

Notwithstanding the lack of legislative history and statutory guidelines, the EEOC and courts have made it clear that discrimination must be manifested in conduct, not merely in a state of mind.[24] When presented with a claim that some employment-related conduct, such as the discharge or transfer of an unwed mother, is prohibited by Title VII, the courts have initially had to resolve the issue of whether such conduct is discriminatory and whether the discrimination is "on account of sex" for purposes of the statute. In analyzing the decisions, it is again important to keep the statutory framework in mind, for there is often a tendency to examine the

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[20]42 U.S.C. § 2000e-5(b) (Supp. V 1975).

[21]110 CONG. REC. 2577-84 (1964). *See also* Willingham v. Macon Tel. Publishing Co., 507 F.2d 1084 (5th Cir. 1975).

[22]110 CONG. REC. at 2581-82.

[23]H.R. REP. NOS. 92-238 & 92-899, S. REP. NOS. 92-415 & 92-681, 92d Cong., 2d Sess., *reprinted in* [1972] U.S. CODE CONG. & AD. NEWS 2137.

[24]*See, e.g.*, Griggs v. Duke Power Co., 401 U.S. 424 (1971). *See generally* Blumrosen, *Strangers in Paradise: Griggs v. Duke Power Co. and the Concept of Employment Discrimination*, 71 MICH. L. REV. 59, 67 (1972). In order of their historical development, Blumrosen discusses three theories concerning the nature of discrimination: (1) Discrimination consists of acts causing economic harm to an individual that are motivated by personal antipathy to the group of which that individual is a member. Proof of discrimination requires evidence of acts, motive (a mens rea), and harm. (2) Discrimination consists of causing economic harm to an individual by treating members of his minority group in a different and less favorable manner than similarly situated members of the majority group. Proof involves evidence of differential treatment and harm. A defense of justification is available. (3) Discrimination consists of conduct that has an adverse effect on minority group members. A defense of justification for compelling reasons of business necessity is recognized.

employment criterion of illegitimacy to reason that there is no apparent business justification for such a classification and to therefore conclude that the conduct is prohibited under Title VII. As indicated above, the statute provides that a practice must first be found to be discriminatory before the statutory BFOQ exception may be considered. Thus, in attacking an employment policy that adversely affects unwed mothers, it is important to formulate a theory that such conduct is in fact gender-based discrimination. The cases indicate that the courts and the EEOC have evolved three theories in resolving whether discrimination against unwed mothers (or parents) constitutes sex-based discrimination under the statute: (1) Disparity of treatment, (2) disparate impact, and (3) conditions peculiar to female physiology.

At this stage it is important to distinguish between "disparate treatment" and "disparate impact" as theories of discrimination under Title VII. As stated by the Supreme Court in *International Brotherhood of Teamsters v. United States,*[25] with respect to disparate treatment—that is, treating an individual less favorably because of race, color, etc.—proof of discriminatory motive is required, although such a motive can be inferred from the mere fact of differing treatment. Disparate impact involves "employment practices that are facially neutral in their treatment of different groups but that in fact fall more harshly on one group than another and cannot be justified by business necessity. Proof of discriminatory motive . . . is not required under a disparate impact theory."[26]

1. Disparity of Treatment.—Disparity of treatment is perhaps the most easily understood and widely used theory of discrimination, and it has been suggested that this theory was Congress' common understanding of discrimination when Title VII was drafted.[27] Thus, discrimination occurs when the employer treats people less favorably than others because of their race, color, religion, sex, or national origin. For example, in *Phillips v. Martin Marietta Corp.,*[28] the Supreme Court held that persons of like qualifications must be given employment opportunities irrespective of sex, and absent a showing of business justification the statute would not permit one hiring policy for women (*i.e.*, refusing to accept job applications from

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[25]431 U.S. 324, 335 n.15 (1977).

[26]*Id.* (citations omitted).

[27]*See, e.g.*, 110 CONG. REC. 13088 (1964) (remarks of Sen. Humphrey) ("What the bill does . . . is simply to make it an illegal practice to use race as a factor in denying employment. It provides that men and women shall be employed on the basis of their qualification, not as Catholic citizens, not as Protestant citizens, not as Jewish citizens, not as colored citizens, but as citizens of the United States."). *See also* B. SCHLEI & P. GROSSMAN, EMPLOYMENT DISCRIMINATION LAW 1 & n.6 (BNA Books 1976).

[28]400 U.S. 542 (1971).

women with pre-school age children) and another for men—each group having pre-school age children.

In *Wardlaw v. Austin School District*,[29] a district court held that the transfer of a general education teacher after becoming pregnant without intending to marry was not the result of discrimination on account of sex. The court found no disparate treatment because plaintiff had not presented any evidence that male teachers who became parents out of wedlock were treated differently from female teachers who became parents of children out of wedlock. Although the court recognized that such evidence probably would not be available because male teachers do not normally reveal their fatherhood of illegitimate children, it nevertheless concluded that a male teacher who did advise the school administration that he was an unwed parent and that he planned to share this information with his students would presumably be treated the same. The discrimination, reasoned the court, lay in the knowledge available to the administration and not in any disparate treatment of males and females. Such discrimination, concluded the court, was in the availability of knowledge and consequently must be charged to "nature" and not to the school authorities.[30] Likewise, in *Omaha Public Schools v. Brown*,[31] plaintiff, an unwed pregnant teacher, alleged sex-based discrimination inasmuch as no unmarried male teacher in the school system had ever been terminated for being a putative father. Citing the absence of any authority that would allow it to repeal the "biological laws of nature," the Nebraska court found no impermissible discrimination.

The rationale of *Wardlaw* and *Brown* was rejected in *Leechburg Area School District v. Pennsylvania Human Relations Commission*.[32] In *Leechburg*, the school district required teachers to begin a maternity leave without pay at the end of the sixth month of pregnancy. In addition, the school district limited maternity leave to *married* teachers. Consequently, the effect of denying maternity leave to an unwed pregnant female was to terminate her employment. The Pennsylvania court had little trouble in deciding that the mandatory maternity leave policy was discriminatory under the Pennsylvania Human Relations Act.[33] However, the court voiced dif-

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[29]10 Fair Empl. Prac. Cas. 892 (W.D. Tex. 1975). *Wardlaw* was argued under Title VII, the first, ninth, and fourteenth amendments of the United States Constitution, the Texas Constitution, and a Texas statute. For a general discussion of the differing standards applied to constitutional and Title VII claims, *see* notes 150-179 *infra* and accompanying text.

[30]10 Fair Empl. Prac. Cas. at 894.

[31]13 Fair Empl. Prac. Cas. 767 (Neb. Dist. Ct. 1976).

[32]19 Pa. Commw. Ct. 614, 339 A.2d 850 (1975).

[33]Pennsylvania Human Relations Act of 1965, § 3, PA. STAT. ANN. tit. 43, § 955 (Purdon Supp. 1977). The statute provides in pertinent part:

ficulty in finding that the limitation of maternity leave to married teachers amounted to sex discrimination under the state statute. The court reasoned that limitation of maternity leave eligibility to married teachers would appear to be discriminatory on the basis of marital status rather than sex, and discrimination based upon marital status per se is not prohibited sex discrimination under the statute.[34] Nevertheless, the court concluded that the effect of the policy was to penalize the unwed female employee in absence of evidence that the school had adopted a mandatory termination policy for unwed male teachers who had fathered illegitimate children or had otherwise participated in extramarital sex.[35]

In contrast to *Leechburg*, the *Wardlaw* court held that such a policy was not discriminatory in absence of any evidence that the school superintendent would treat unwed male teachers who admitted that they were fathers differently from unwed female teachers.[36] The *Wardlaw* court effectively established the *presumption* that discrimination against unwed mothers is not gender-based discrimination unless the plaintiff demonstrates that the employer *would* treat the sexes differently with respect to the status of becoming an unwed parent. However, the *Wardlaw* approach effectively precludes a finding of sex-based discrimination unless (1) an unwed father voluntarily admits his status to school authorities, or (2) the school maintains an efficient investigative force that is capable of discovering the parental status of its male teachers. Aside from constitutional problems, it is difficult to imagine what methods a school-sponsored investigative force would use to determine the paternity status of its unwed male teachers. Furthermore, it strains credulity to premise the validity of a legitimacy policy on the notion that those males who do come forward and announce their status as unwed parents will be treated the same as women. Although such a policy facially purports to treat both males and females alike, the application of the policy demonstrates that such is clearly not the case. Accordingly, the courts have utilized a

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> It shall be an unlawful discriminatory practice, unless based upon a bona fide occupational qualification . . . (a) For any employer because of the . . . sex . . . of any individual to refuse to hire or employ, or to bar or to discharge from employment such individual or otherwise to discriminate against such individual with respect to compensation, hire, tenure, terms, conditions or privileges of employment, if the individual is best able and most competent to perform the services required.

[34]The court noted that the questions whether such a classification would contravene the requirement of substantive due process of equal protection were questions not then before the court. 19 Pa. Commw. Ct. at 616, 339 A.2d at 852.

[35]*Id.* at 616, 339 A.2d at 853.

[36]10 Fair Empl. Prac. Cas. at 894.

"disparate impact" theory in finding legitimacy policies discriminatory.

2. Disparate Impact.—Even if an employer purports to treat males and females alike under a policy whereby *all* unwed parents are discharged, such a policy can, nevertheless, be found to be discriminatory on the basis of sex. The *Leechburg* court appeared to indicate that adoption of a policy that applied to all unwed parents would still be actionable as discriminatory, since the brunt of the policy would be directed solely at unmarried female teachers due to the obvious physiological visibility of their pregnant condition.[37] Although members of each sex should be treated the same with respect to the actual terms of the policy, a disparate impact would appear once the policy was applied or enforced, thus resulting in sex-based discrimination.

In the general context of sex discrimination, the Supreme Court, in *Dothard v. Rawlinson,*[38] applied a disparate impact rationale in finding that Alabama's statutory minimum height and weight requirements for a position of correctional counselor[39] violated Title VII. The Court found that a 5-foot-2-inch height minimum operated to exclude 33.29% of the women in the United States between the ages of 18 and 79, while excluding only 1.28% of the men in the same group. Furthermore, the 120-pound weight requirement excluded 22.29% of the women and 2.35% of the men in this same age group.[40] In finding these hiring requirements to be discriminatory, the Court reaffirmed its decision in *Griggs v. Duke Power:*[41]

> [T]o establish a prima facie case of discrimination, a plaintiff need only show that the facially neutral standards in question select applicants for hire in a significantly discriminatory pattern. Once it is thus shown that the employment standards are discriminatory in effect, the employer must meet "the burden of showing that any given requirement [has] . . . a manifest relation to the employment in question."[42]

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[37]19 Pa. Commw. Ct. at 617, 339 A.2d at 853. The court further stated: "The effect of the statute is not to be diluted because discrimination adversely affects only a portion of the protected class." *Id.* (quoting Sprogis v. United Air Lines, Inc., 444 F.2d 1194, 1198 (7th Cir.), *cert. denied,* 404 U.S. 991 (1971).

[38]433 U.S. 321 (1977).

[39]ALA. CODE tit. 55, § 373(109) (Supp. 1973).

[40]433 U.S. at 329.

[41]401 U.S. 424 (1975) (requirement of general intelligence test as prerequisite for hire held discriminatory where test operated to disqualify a higher percentage of black than white applicants). *See also* Gregory v. Litton Syss., Inc., 472 F.2d 631 (9th Cir. 1972) (arrest records).

[42]433 U.S. at 329 (quoting Griggs v. Duke Power Co., 401 U.S. at 432).

The Court further stated: "If the employer proves that the challenged requirements are job related, the plaintiff may then show that other selection devices without a similar discriminatory effect would also 'serve the employer's legitimate interest in "efficient and trustworthy workmanship." ' "[43]

In *McDonnell Douglas Corp. v. Green,*[44] the Supreme Court addressed the order and allocation of proof in a Title VII action challenging employment discrimination on account of race. The Court held that the complainant must carry the initial burden of establishing a prima facie case of racial discrimination. This may be done by proving the following facts: (1) That complainant belongs to a racial minority; (2) that he applied and was qualified for a job for which the employer was seeking applicants; (3) that despite his qualifications, he was rejected; and (4) that, after his rejection, the position remained open and the employer continued to seek applications from persons of complainant's qualifications.[45]

Moreover, in *McDonald v. Sante Fe Trail Transportation Co.,*[46] the Supreme Court interpreted *McDonnell Douglas* as only requiring that the complainant show that race was but one factor, not the sole cause, of an employer's adverse action. Thus, once plaintiff has made out a prima facie case, the burden then shifts to the employer to articulate some legitimate nondiscriminatory reason for respondent's rejection of the applicant. Furthermore, even though an employer offers some legitimate reason for imposing some adverse action on complainant, the complainant, nevertheless, is afforded a fair opportunity to demonstrate that respondent's reasons are pretextual.[47] Although *McDonnell Douglas* involved race discrimination, the same rule generally applies by analogy to sex discrimination cases.[48]

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[43]*Id.* (quoting Albemarle Paper Co. v. Moody, 422 U.S. 405, 425 (1975) (quoting McDonnell Douglas Corp. v. Green, 411 U.S. 792, 801 (1973))). The Court went on to rule that the defendant failed to rebut plaintiff's prima facie case; however, the majority held that excluding women from certain body contact positions fit the bona fide occupational qualifications to the proscription of sex discrimination. Justice Stewart, writing for the majority, reasoned that the "jungle atmosphere" of the Alabama prison system warranted the exclusion of women from the position of correctional counselor in the male maximum security institution. 433 U.S. at 334-36.

[44]411 U.S. 792 (1973).

[45]*Id.* at 802.

[46]427 U.S. 273, 282 n.10 (1976).

[47]McDonnell Douglas Corp. v. Green, 411 U.S. 792 (1973).

[48]In this regard, *see* East v. Romie, Inc., 518 F.2d 332 (5th Cir. 1975); Meadows v. Ford Motor Co., 510 F.2d 939 (6th Cir. 1975); Jurinko v. Edwin Weigand Co., 477 F.2d 1038 (3d Cir. 1973) (remanded for further consideration in light of *McDonnell Douglas*); Davis v. Weidner, 421 F. Supp. 594 (E.D. Wis. 1976); White v. Bailar, 14 Fair Empl. Prac. Cas. 383 (E.D. Wis. 1976). *But see* King v. New Hampshire Dep't of Resources &

The courts and the EEOC have readily used the "disparate impact" theory in finding sex-based discrimination in those cases where a rule is facially neutral, proscribing the employment of any parent, male or female, of an illegitimate child. In *Andrews v. Drew Municipal Separate School District*,[49] a federal district court held that a rule banning parents of illegitimate children from employment in a school[50] was unconstitutional because it amounted to sex-based discrimination against women. The court stated that although the policy professed to be neutral, such a rule could not possibly operate in a neutral fashion, as evidenced by the fact that only unmarried females had been prohibited from employment under the policy. Indeed, "[u]nless the man either admits paternity or is so adjudged judicially, it is virtually impossible to prove his involvement. Nature does not readily, if ever, identify the offspring's sire."[51] It is noteworthy that the court found the policy to be discriminatory despite the school's emphatic assurance that the policy would be applied equally to both male and female employees.[52]

The EEOC similarly applied the disparate impact theory in finding that refusal to hire an unwed mother discriminated against the applicant on the basis of sex. In a 1970 decision,[53] the EEOC ruled that such an legitimacy-of-birth standard for employment, even if sought to be applied equally to unwed fathers, had the foreseeable and certain impact of depriving females, but not similarly situated males, of employment opportunities.[54]

Economic Dev., 562 F.2d 80, 83 (1st Cir. 1977), in which the court cited McDonnell Douglas Corp. v. Green, 411 U.S. at 802 n.13, for the proposition that "listed specifications for prima facie proof would not necessarily apply in different factual situations." The *King* court held that the applicant had established a prima facie case, notwithstanding the fact that the job position did not remain open. *Id.*

[49]371 F. Supp. 27 (N.D. Miss. 1973), *aff'd*, 507 F.2d 611 (5th Cir. 1975).

[50]No consideration was given to the subsequent marriage of the parent, to the length of time elapsed since the illegitimate birth, or to a person's reputation in the community. The court found such a presumption to be "patently absurd," "mischievous," and "prejudicial." 371 F. Supp. at 34.

[51]*Id.* at 35.

[52]*Id.* *See also* discussion of Flores v. Secretary of Defense, 355 F. Supp. 93 (N.D. Fla. 1973), notes 193-196 *infra* and accompanying text.

[53][1973] EEOC Decisions (CCH) ¶ 6164 (1970).

[54]In another 1970 decision, the EEOC held that an employer's policy of limiting maternity leave to "married" women discriminated against females because of sex, at least in absence of evidence that provision had been made for termination of an unmarried father under the collective bargaining agreement. [1973] EEOC Decisions (CCH) ¶ 6184 (1970). Whether such a showing would have saved the policy is open to speculation. Even if the illegitimacy standard had been applied to unmarried males, it still would have had the foreseeable impact of depriving females, but not similarly placed males, of employment opportunities.

3. Conditions Peculiar to the Female Physiology.—In *Jane Doe v. Osteopathic Hospital*,[55] a federal district court held that the discharge of a female employee by a hospital because the employee was pregnant and unmarried was prohibited by Title VII. The hospital argued that since it had not discriminated in favor of "pregnant, unmarried men," plaintiff should not be entitled to relief.[56] The court reasoned that since the condition of being visibly pregnant and unwed was a "condition peculiar to the female physiology alone," and since there was no evidence that the plaintiff's marital state of pregnancy had any relationship to the performance of her duties, the hospital was guilty of discrimination.[57]

Likewise, in *Jacobs v. Martin Sweets Co.*,[58] the Sixth Circuit Court of Appeals held that an employer had violated Title VII by constructively discharging an unwed pregnant female. In *Jacobs*, the defendant-employer argued that it had not discriminated within the meaning of Title VII because plaintiff had failed to demonstrate that she would have received different treatment if she had been a male expectant parent. In addition, defendant argued that there had been no showing that plaintiff would have received different treatment if her premarital sexual activity had not resulted in pregnancy. Both arguments were rejected by the Sixth Circuit. With respect to the first argument, the court stated that the employer was attempting to equate a female's pregnancy with the condition of an expectant male parent. Since pregnancy is a condition unique to females, the termination of employment based on pregnancy necessarily had a disparate and invidious impact upon the female sex. The main point with respect to the employer's first argument, the court noted, was that there must be men and women similarly situated who are treated in a disparate manner before the statute is violated. However, as the court cogently reasoned, to accept this argument would effectively exclude pregnancy from all Title VII cases,[59] a proposition recently rejected by the Supreme Court.[60]

With regard to the second argument, the court reasoned that the district court had found that the discharge occurred because plaintiff was unmarried and pregnant, not because of her premarital sexual activity. As stated by the Sixth Circuit, the second argument suggests that Title VII prohibits " 'artificial, arbitrary, and unnecessary barriers to employment' in the case of unwed pregnancy,

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[55]333 F. Supp. 1357 (D. Kan. 1971).

[56]*Id.* at 1362.

[57]*Id.*

[58]550 F.2d 364 (6th Cir.), *cert. denied*, 431 U.S. 917 (1977).

[59]*Id.* at 370-71.

[60]*See* discussion of Nashville Gas Co. v. Satty, 98 S. Ct. 347 (1977), in note 88 *infra* and accompanying text.

while declaring such barriers lawful in the case of a wed pregnancy."[61] However, there was no evidence that the *Jacobs* classification had any rational relationship to the normal operation of the business.[62]

In concluding that the legitimacy-of-birth policies at issue were discriminatory under Title VII, the *Doe* and *Jacobs* courts appeared to base their decisions on the fact that pregnancy is a condition unique to the female physiology. In this regard, two points are especially noteworthy. First, although the result in both decisions would appear to be correct, the *Doe* opinion failed to clarify whether the discharge was discriminatory merely because it was based on a condition "peculiar to the female physiology," or because the condition of being an unwed female had no relation to job performance.[63] Arguably, the *Doe* district court may have examined the criteria of "visibly pregnant" and "unwed," found that there was no evidence that either affected plaintiff's job performance, and thus concluded that there had been discrimination.[64]

As indicated earlier,[65] even if the employment criterion of legitimacy is demonstrably unrelated to job performance, the use of such a criterion is not prohibited by Title VII unless it is first found to be a form of discrimination prohibited by the statute, which in most cases will be sex-based discrimination.[66] It is also noteworthy

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[61]550 F.2d at 371 (quoting Griggs v. Duke Power Co., 401 U.S. 424, 431 (1971)).

[62]*See* discussion of Jacobs v. Martin Sweets Co., 550 F.2d at 371, in text accompanying notes 58-59 *supra*.

[63]The *Doe* court may have applied a "disparate impact" theory in finding that the discharge was sex-based discrimination. Quoting *Sprogis*, the court stated:

> The scope of [the statute] is not confined to explicit discrimination based 'solely' on sex. In forbidding employers to discriminate against individuals because of their sex, Congress intended to strike at the . . . sex stereotypes. . . . The effect of the statute is not to be diluted because discrimination adversely affects *only* a portion of the protected class. Discrimination is not to be tolerated under the guise of physical properties possessed by one sex . . . or through the unequal application of a seemingly neutral company policy.

333 F. Supp. at 1362 (quoting Sprogis v. United Air Lines, Inc., 444 F.2d at 1198) (emphasis supplied by *Doe* court).

[64]The court further stated that it was irrelevant that there had been no other known females discharged by defendants because the statute prohibits discrimination against any individual. 333 F. Supp. at 1362. In addition, the court noted that if plaintiff was discharged by defendants because she failed to give notice of her pregnant condition, such a termination would likewise constitute unlawful discrimination "in that she was dismissed for failure to exercise an arbitrary duty not imposed upon any member of the male sex, and totally unrelated to job performance." *Id.* at 1363.

[65]*See* note 17 *supra* and accompanying text.

[66]It is noteworthy that discriminatory treatment against unwed mothers has been successfully attacked as race discrimination. In Cirino v. Walsh, 321 N.Y.S.2d 493 (Sup. Ct. 1971), a Puerto Rican mother of eight children by five different fathers was denied the position of crossing guard by the police department because she lacked good

that not all policies that affect or are based on conditions unique to female physiology are necessarily prohibited under Title VII.[67] For example, in *General Electric Co. v. Gilbert*,[68] the Supreme Court held that it was not gender-based discrimination for an employer to exclude pregnancy-related disabilities from its general disability program.[69] Although pregnancy is unique to female physiology, the *Gilbert* court stated: "[I]t is in other ways significantly different from the typical covered disease or disability."[70] Accordingly, merely asserting that a legitimacy policy affects conditions "unique to the female physiology" may not be sufficient grounds for concluding that the policy is discriminatory for purposes of Title VII. Although the *Doe* and *Jacobs* courts appeared to base their decisions on a female physiology theory of discrimination, a female attacking an employer's legitimacy policy after *Gilbert* should also focus on the disparate impact of such a policy.

In *Nashville Gas Co. v. Satty*,[71] a case decided subsequent to *Gilbert*, Nashville Gas, the petitioner-employer, had initiated a policy of requiring pregnant employees to take a formal leave of absence. Although sick pay was generally available to employees disabled by reason of nonoccupational sickness or injury, no benefits were available for disability or sickness due to pregnancy. In addition, an employee returning after a pregnancy leave was denied all accumulated seniority. An employee who wished to return to work was placed in any open permanent position for which she was qualified and for which no current employee was bidding. Until such a permanent position became available, the employer attempted to find temporary work for the employee. If the employee acquired a permanent position, she regained previously accumulated seniority for purposes of pension, vacation, and the like, but did not regain it for the purpose of bidding on future job openings.

The Supreme Court held that the policy of denying accumulated seniority to female employees returning from pregnancy leave

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character. Citing a *New York Times* study, the court noted that one out of four Puerto Rican births are illegitimate as compared to one out of fifteen for the population as a whole. To deny plaintiff the position because of her children was discrimination on the account of race as well as sex. In *Cirino*, the court found that sex discrimination could result "if the fact of children is more easily discovered about the mother who looks after them than the father who does not." *Id.* at 495. Likewise, the EEOC has held that the failure to hire a black unwed mother had a discriminatory effect on blacks as a class when it was shown that at least 80% of the illegitimate births occurring within the area are born to nonwhite females. [1973] EEOC Decisions (CCH) ¶ 6164 (1970).

[67] *See, e.g.*, Geduldig v. Aiello, 417 U.S. 484 (1974).

[68] 429 U.S. 125 (1976).

[69] *See* notes 82-84 *infra* and accompanying text.

[70] 429 U.S. at 136.

[71] 98 S. Ct. 347 (1977).

violated section 703(a)(2) of Title VII.[72] Justice Rehnquist, writing the opinion for the Court, stated that Nashville's decision not to treat pregnancy as a disease or disability for purposes of seniority retention was not on its face a discriminatory policy even though pregnancy is confined to women, because "it is in other ways significantly different from the typical covered disease or disability."[73] The Court reasoned that unlike the contested policy in *Gilbert*, Nashville had "not merely refused to extend to women a benefit that men cannot and do not receive, but has imposed on women a substantial burden that men need not suffer."[74] In this regard, the Court further stated that the distinction between benefits and burdens is more than one of semantics. As explained by Justice Rehnquist:

> We held in *Gilbert* that § 703(a)(1) did not require that greater economic benefits be paid to one sex or the other "because of their different roles in the scheme of existence." But that holding does not allow us to read § 703(a)(2) to permit an employer to burden female employees in such a way as to deprive them of employment opportunities because of their different role.[75]

Accordingly, the Court invalidated Nashville's loss-of-seniority policy.[76]

Justice Stevens, concurring in the judgment, noted that the effect of Nashville's seniority plan was significantly different from the General Electric plan in *Gilbert*. He suggested that "although the *Gilbert* Court was unwilling to hold that discrimination against pregnancy—as compared with other physical disabilities—is discrimination on account of sex, it may nevertheless be true that discrimination against pregnant or formerly pregnant employees—as compared with other employees—does constitute sex

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[72]42 U.S.C. § 2000e-2 (1976). *See* note 12 *supra*.

[73]98 S. Ct. at 350 (citing General Elec. Co. v. Gilbert, 429 U.S. at 136).

[74]98 S. Ct. at 351.

[75]*Id.* (quoting General Elec. Co. v. Gilbert, 429 U.S. at 139 n.17). As noted by Justice Stevens in his dissenting opinion, the Court suggested that its analysis of the seniority plan was different because that plan was being attacked under § 703(a)(2) of Title VII, whereas the plan in *Gilbert* was found to be violative of § 703(a)(1). Stevens noted that although § 703(a)(1) refers to "discrimination" and § 703(a)(2) does not, this distinction is not relevant since the Court itself recognizes that a violation of § 703(a)(2) occurs when a facially neutral policy has a "discriminatory effect." 429 U.S. at 161 n.4 (Stevens, J., dissenting).

[76]With respect to Nashville's exclusion of pregnancy-related disabilities from its sick-pay policy, the Court remanded the issue to the district court for a determination of whether the policy violated Title VII based upon a discriminatory effect theory. 98 S. Ct. at 353.

discrimination."[77] Justice Stevens further noted that the General Electric plan and the Nashville seniority plan could be pragmatically distinguished as to whether the employer has a policy which adversely affects females beyond the term of their pregnancy leaves.[78]

4. Summary.—Notwithstanding the *Wardlaw* decision,[79] an employer will not be able to successfully argue that an employment criterion of illegitimacy is not discriminatory in that it is equally applicable to males and females. As indicated by the *Sprogis* court: "Discrimination is not to be tolerated under the guise of physical properties possessed by one sex . . . or through the unequal application of seemingly neutral company policy."[80] A legitimacy standard will have the foreseeable and certain impact of depriving females, but not similarly placed males, of employment opportunities. Discrimination that only affects a portion of a protected class will not defeat relief under the statute. An employer will not be able to successfully defend by asserting that it is not discriminatory to treat a subclass (unwed and pregnant females) within a protected class (all females) disparately, for it is now settled that disparate treatment with respect to a subclass of one sex can indeed be sex-based discrimination under Title VII.[81]

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[77]*Id.* at 358.

[78]*Id.*

[79]*See* note 29 *supra* and accompanying text.

[80]Sprogis v. United Air Lines, Inc., 444 F.2d 1194, 1198 (7th Cir. 1971).

[81]The issue of discrimination between different categories of the same sex has been one that has repeatedly occupied the courts. *See* Phillips v. Martin Marietta Corp., 400 U.S. 542 (1971) (failure to hire women with preschool-age children, while hiring similarly situated males was discriminatory, even though the company hired 70 to 75% women); Willingham v. Macon Tel. Publishing Co., 507 F.2d 1084 (5th Cir. 1975) (grooming regulation applicable to males with long hair not sex-based discrimination since employer applied personal grooming code to all employees); Sprogis v. United Air Lines, Inc., 444 F.2d 1194 (7th Cir. 1971) (unlawful to restrict employment of married females but not married males, even though most flight attendants were females). The classification of employees on the basis of sex plus some other ostensibily neutral characteristic has generally been termed "sex-plus" discrimination. As stated by the Fifth Circuit in *Willingham:*

> The practical effect of interpreting [42 U.S.C. § 2000e-2] to include this type of discrimination is to impose an equal protection gloss upon the statute, i.e. similarly situated individuals of either sex cannot be discriminated against vis-a-vis members of their own sex unless the same distinction is made with respect to those of the opposite sex. Such an interpretation may be necessary in order to counter some rather imaginative efforts by employers to circumvent [42 U.S.C. § 2000e-2].

507 F.2d at 1089. It is noteworthy that Congress specifically defeated an amendment which would have added the word "solely" to the bill, modifying "sex," 110 CONG. REC. 2728 (1964), thereby providing some legislative support for the inclusion of "sex-plus" discrimination within the proscription of § 703. *See* Willingham v. Macon Tel.

Finally, an additional argument may arise after the recent decision by the Supreme Court in *General Electric Co. v. Gilbert.*[82] In *Gilbert*, a divided Court held that it was not a violation of Title VII for an employer to exclude pregnancy disability from coverage of its general disability benefits plan. Justice Rehnquist, writing for the majority, reasoned that the plan did not operate to discriminate against women in terms of the aggregate risk protection that was provided to employees. Citing *Geduldig v. Aiello*,[83] a similar case involving the exclusion of pregnancy disabilities from the state of California's disability program, the majority stated that discrimination was absent since "there is no risk from which men are protected and women are not. Likewise, there is no risk from which women are protected and men are not."[84]

Publishing Co., 507 F.2d at 1089. In addition, the EEOC has stated in its *Guidelines* that "so long as sex is a factor in the application of the rule [restricting the employment of married women], such application involves a discrimination based on sex." 29 C.F.R. § 1604.4(a) (1976).

While it is clear that not every dissimilarity in employment requirements respectively set for the sexes impinges on Title VII, General Elec. Co. v. Gilbert, 429 U.S. at 135, courts have generally held that those "plus" factors which are based on "immutable" characteristics will warrant a finding of sex discrimination. *See, e.g.*, Barnes v. Costle, 561 F.2d 983, 990-91 (D.C. Cir. 1977) (citing Dodge v. Giant Food, Inc., 488 F.2d 1333, 1337 (D.C. Cir. 1973)); Fagen v. National Cash Register Co., 481 F.2d 1115 (D.C. Cir. 1973).

In addition, the Supreme Court has held that those differentials that have a significant effect on employment opportunities of one sex will warrant a finding of sex discrimination. Nashville Gas Co. v. Satty, 98 S. Ct. 347 (1977). Moreover, courts are receptive to finding discrimination based on constitutionally protected activities such as marriage or child-rearing because they present insurmountable obstacles to one sex. Earwood v. Continental Southeastern Lines, Inc., 539 F.2d 1349 (4th Cir. 1976) (dicta).

[82]429 U.S. 125 (1976).

[83]417 U.S. 484 (1974). *Geduldig* was decided under the equal protection clause of the fourteenth amendment. In that decision the Court held that exclusion of pregnancy-related disabilities under California's disability program did not amount to invidious discrimination under the United States Constitution. The majority reasoned that the state had legitimate interests in maintaining the self-supporting nature of the program, as well as maintaining a contribution rate that was not unduly burdensome on current participating employees.

[84]429 U.S. at 146-160 (citing Geduldig v. Aiello, 417 U.S. at 496-97). Justices Brennan and Marshall, dissenting, argued that General Electric's policy "as a neutral process of sorting risks" and "not a gender-based discrimination" cannot be squared with the facts of the case. The dissent noted that the plan does in fact insure against some risks that are specific to the reproductive system of men for which there exist no female counterparts covered by the plan. *Id.* at 148 (Brennan & Marshall, JJ., dissenting). In addition, the dissent attacked the majority's reading of the EEOC's 1972 interpretative guideline requiring pregnancy to be treated like any other temporary disability, 29 C.F.R. § 1604.10(b)(1972). Brennan found no basis for concluding that the regulation was out of step with congressional intent, 429 U.S. at 156-58, and indeed argued that Congress intended a contrary result from that reached by the majority. *Id.* at 157-58.

Accordingly, the argument can be made that if it is not gender-based discrimination to exclude all females with pregnancy-related disabilities from a general disability program, it is likewise not discriminatory to exclude all *unwed* females with a pregnancy-related disability from such a program. This argument was raised in *Willett v. Emory College*,[85] when a district court, citing *Gilbert*, held that a health insurance plan that only awarded pregnancy coverage to those employees having dependents and therefore did not provide pregnancy benefits to unmarried females would not give rise to a cause of action under Title VII. The court recognized that a prima facie violation of Title VII may be established in some circumstances upon proof that the effect of an otherwise facially neutral plan is to discriminate against females, but the Emory program did not present such a violation, since the contested plan clearly provided benefits for married female employees.[86]

As characterized by the Sixth Circuit in *Jacobs v. Martin Sweets Co.*,[87] this argument essentially reduces to the issue of whether the holding in *Gilbert*—that exclusion of pregnancy from the risks covered by an employer's disability benefits plan is not a violation of Title VII—can be regarded as precedent for excluding pregnancy from protection against invidious employment discrimination, a proposition that was considered and rejected by the *Jacobs* court. Although the result would appear to be correct, the reasoning of the Sixth Circuit in *Jacobs* is arguably suspect. Title VII clearly does not prohibit all forms of invidious discrimination, but only discrimination in employment based on race, color, religion, sex, and national origin. In addition, while it is true that only women can become pregnant, it does not necessarily follow that every classification concerning pregnancy is a gender-based classification for purposes of Title VII. Still, the situation in *Gilbert* can be distinguished from the unwed parent case (exclusion of unwed parents from employment or other employment-related benefits). In *Gilbert*, the line or classification was not drawn between men and women, but rather between women with a pregnancy-related disability and other women and men without that disability. In the unwed parent situation, the de jure classification is between men and women who are parents and unwed, and all other men and women. However, the unwed parent case effectively results in a form of de facto discrimination on account of sex, whereas the *Gilbert* disqualification arose from a disability based on protection from certain risks, and, as stated in *Gilbert*, was not a gender-based classification.

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[85]427 F. Supp. 631 (W.D. Va. 1977).

[86]*Id.* at 636-37.

[87]550 F.2d 364 (6th Cir.), *cert. denied*, 431 U.S. 917 (1977).

Stated another way, the distinction is between a "pregnancy-controlled" decision in *Gilbert* and the "sex-controlled" decision in the unwed parent case.

Nashville Gas Co. v. Satty[88] provided further support for the proposition that the *Gilbert* decision does not authorize the exclusion of unwed mothers from employment opportunities. If, as stated by Justice Rehnquist in *Satty*, the policies at issue in *Gilbert* (exclusion of pregnancy-related disabilities from employer's disability program) and *Satty* (denial of accumulated seniority to females returning from pregnancy leave) are to be respectively distinguished on the basis of benefits conferred and burdens imposed,[89] such reasoning arguably supports the proposition than an employer cannot, under Title VII, exclude females from employment opportunities merely because they are unwed mothers. An employment criterion of legitimacy-of-birth may resemble the invalid *Satty* policy in that it deprives females of employment opportunities and adversely affects their status as employees, resulting in a violation of section 703(a)(2) of Title VII.[90] Unlike the situation in *Gilbert*, where there was no showing that a policy of compensating for all non-job-related disabilities except pregnancy favored men over women, a legitimacy standard, even if applicable to both male and female unwed parents, clearly burdens females and not males for the simple reason that male unwed parents are virtually impossible to detect.

C. Discrimination Against Unwed Mothers as a Bona Fide Occupational Qualification

Once it is determined that a legitimacy standard is sex-based discrimination, the employer has the option to demonstrate that the discrimination is justified as a bona fide occupational qualification (BFOQ) reasonably necessary to the normal operation of the business.[91] The BFOQ exception has been narrowly construed by both the EEOC[92] and the courts. For example, in *Diaz v. Pan*

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[88]98 S. Ct. 347 (1977). *See* discussion in notes 71-78 *supra* and accompanying text.

[89]98 S. Ct. at 351. Justice Stevens, in his concurring opinion, found difficulty with this line of reasoning. Characterizing this distinction as illusory, Justice Stevens noted: "Differences between benefits and burdens cannot provide a meaningful test of discrimination since, by hypothesis, the favored class is always benefited and the disfavored class is equally burdened." *Id.* at 357 n.4. As indicated earlier Justice Stevens offered an alternative to the Court's reasoning which, a priori, appeared more sound than that of the majority. *See* notes 77-78 *supra* and accompanying text.

[90]42 U.S.C. § 2000e-2 (Supp. V 1975).

[91]*See* note 19 *supra* and accompanying text.

[92]The EEOC's Guidelines on Sex Discrimination provide in part:

> The commission believes that the bona fide occupational qualification exception as to sex should be interpretated narrowly. Label[s]—"Men's jobs"

American World Airways,[93] the Fifth Circuit Court of Appeals held that "discrimination based on sex is valid only when the *essence* of the business operation would be undermined by not hiring members of one sex exclusively."[94] Likewise, in *Weeks v. Southern Bell Telephone & Telegraph Co.*,[95] the same court held that an employer could rely on the BFOQ exception only by showing "that he had reasonable cause to believe, that is, a factual basis for believing, that all or substantially all women would be unable to perform safely and efficiently the duties of the job involved."[96] More importantly, in *Dothard v. Rawlinson*,[97] the Supreme Court stated for the first

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and "Women's jobs"—tend to deny employment opportunities unnecessarily to one sex or the other.

(1) The commission will find that the following situations do not warrant the application of the bona fide occupational qualification exception:

(i) The refusal to hire a woman because of her sex based on assumptions of the comparative employment characteristics of women in general. For example, the assumption that the turnover rate among women is higher than among men.

(ii) The refusal to hire an individual based on stereotyped characterizations of the sexes. Such stereotypes include, for example, that men are less capable of assembling intricate equipment; that women are less capable of aggressive salesmanship. The principle of nondiscrimination requires that individuals be considered on the basis of individual capacities and not on the basis of any characteristics generally attributed to the group.

(iii) The refusal to hire an individual because of the preferences of coworkers, the employer, clients or customers except as covered specifically in paragraph (a)(2) of this section.

(2) Where it is necessary for the purpose of authenticity or genuineness, the commission will consider sex to be a bona fide occupational qualification, e.g., an actor or actress.

29 C.F.R. § 1604 (1976).

[93] 442 F.2d 385 (5th Cir. 1971).

[94] *Id.* at 388 (emphasis in original).

[95] 408 F.2d 228 (5th Cir. 1969).

[96] *Id.* at 235. The *Weeks* test—that an employer must show a factual basis for believing that "all or substantially all women would be unable to perform safely an efficiently the duties of the job involved"—has been subjected to criticism for its failure to require an employer to allow for individual testing or, alternatively, to demonstrate that individual testing is impossible. *See* Phillips v. Martin Marietta Corp., 400 U.S. 542 (1971) (Marshall, J., concurring); Bowe v. Colgate-Palmolive Co., 416 F.2d 711 (7th Cir. 1969) (individual testing required); *Developments in the Law—Employment Discrimination and Title VII and the Civil Rights Act of 1964*, *84* HARV. L. REV. 1109, 1179-81 (1971). Notwithstanding the criticism, the Supreme Court cited the *Weeks* test with approval in dictum in Dothard v. Rawlinson, 433 U.S. 321, 333 (1977). The *Weeks* test is arguably sound, for if the BFOQ exception is interpreted to require individual testing, the exception is effectively read out of the statute. Those applicants who fail the ability test can be rejected without regard to the exception. It seems clear that if the BFOQ is to have any substantive meaning, some utilization of the BFOQ defense ought to be permitted, short of proof that 100% of a specific sex are unable to perform a given job.

[97] 433 U.S. 321 (1977).

time in a Title VII case that the restrictive language of section 703(e)—the BFOQ exception—commands that the "exception was in fact meant to be an extremely narrow exception to the general prohibition of discrimination on the basis of sex,"[98] a position to which the EEOC has adhered consistently in its construction of the statute.[99]

In light of the narrow construction given the BFOQ exception by both the courts and the EEOC, it is difficult to defend a legitimacy-of-birth criterion as a qualification reasonably necessary to the normal operation of *any* business, at least in the context of ability to perform a designated job or task. Applying the *Weeks* test, an employer relying on the BFOQ exception would have to factually demonstrate that all or substantially all women who were mothers of illegitimate children would be unable to safely and efficiently perform the duties of the job because of their combined status of being unwed and a mother, an effectively insurmountable burden.[100] Indeed, the cases indicate that rather than trying to defend a legitimacy standard as being directly related to a woman's ability to perform, employers have primarily focused their arguments on the discrimination issues.[101]

In those cases where the BFOQ defense is asserted, employers have attempted to justify their policies under the general cloak of morality, public image, or co-worker preference.[102] For example, in *Leechburg Area School District v. Pennsylvania Human Relations Commission*,[103] the school argued that a legitimacy classification was necessary to maintain the "moral tenor" of the educational environment, a goal that would best be accomplished by discouraging unmarried teachers from becoming pregnant. The court stated that under the BFOQ exception the school would have to establish that all or substantially all unmarried pregnant teachers could not pro-

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[98]*Id.* at 334.

[99]With the exception of the case of state protective legislation, the EEOC's guidelines on sex discrimination have remained virtually unchanged since they were initially issued in November 1965. *Compare* 30 Fed. Reg. 14,926 (1965) (prior version of 29 C.F.R. § 1604) *with* 29 C.F.R. § 1604 (1977).

[100]*See* discussion of Jacobs v. Martin Sweets Co., 550 F.2d 364 (6th Cir. 1977), in notes 58-59 *supra* and accompanying text.

[101]Jacobs v. Martin Sweets Co., 550 F.2d 364 (6th Cir. 1977); Cirino v. Walsh, 321 N.Y.S.2d 493 (Sup. Ct. 1971); [1973] EEOC Decisions (CCH) 4275 (1970).

[102]Wardlaw v. Austin Independent School Dist., 10 Fair Empl. Prac. Cas. 892 (W.D. Tex. 1975); Andrews v. Drew Mun. Separate School Dist., 371 F. Supp. 27 (N.D. Miss. 1973), *aff'd*, 507 F.2d 611 (5th Cir. 1975); Cirino v. Walsh, 321 N.Y.S.2d 493 (Sup. Ct. 1971); Doe v. Osteopathic Hosp., 333 F. Supp. 1357 (D. Kan. 1971).

[103]19 Pa. Commw. Ct. 614, 339 A.2d 850 (1975). *See also* notes 32-34 *supra* and accompanying text.

vide the proper moral model believed to be necessary for school-age children. Furthermore, the school presented no evidence that a teacher who is unmarried and pregnant could not continue to maintain the respect of her students and serve as "a proper moral polestar to her impressionable charge."[104]

Likewise, in *Doe v. Osteopathic Hospital,*[105] the district court rejected a claim by a hospital that a policy of denying an unmarried female maternity leave (an effective discharge of the employee under the hospital's policy) was necessary to protect the hospital's public image and the morale of its employees. In *Doe*, the court correctly refused to assume that the public image of the hospital would be damaged merely by the retention of an unmarried pregnant female.[106] In this regard, it is noteworthy that the court did not hold that morality or public image concern were impermissible considerations under Title VII. Rather, the court stated that in absence of evidence that the hospital's public image was damaged or that the morale of its employees was adversely affected, a BFOQ would not be established.[107]

In summary, the line of analysis taken by the courts that have considered the claim that a legitimacy standard is privileged under the BFOQ exception is generally consistent with the narrow construction given the BFOQ exception by the courts and the EEOC. As indicated earlier, the Supreme Court had recently stated that the BFOQ exception is meant to be construed extremely narrowly,[108] a view consistent with that of the EEOC.[109] Mere claims that a legitimacy policy is necessary to maintain a proper moral tenor or to satisfy customer or co-worker preferences will not suffice to accord a legitimacy standard refuge under the BFOQ exception. Given this narrow focus, it is understandable why employers have generally tended to argue that a legitimacy policy is not discriminatory rather

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[104]19 Pa. Commw. Ct. at 618, 339 A.2d at 854. In Wardlaw v. Austin Independent School Dist., 10 Fair Empl. Prac. Cas. 892 (W.D. Tex. 1975), a case decided under the United States Constitution, the district court indicated that the composition of the student body may indeed be important when analyzing legitimacy standards. The court found the plaintiff's special education class containing mentally retarded children "might be particularly vulnerable to harm arising from any tension resulting from differences between their parents and their teacher regarding sexuality attitudes and lifestyles." *Id.* at 895. Accordingly, the court found that the decision to transfer an unwed pregnant teacher was based on "legitimate educational concerns" and a desire "to perpetuate public confidence in the educational system." *Id.*

[105]333 F. Supp. 1357 (D. Kan. 1971).

[106]*Id.* at 1360.

[107]*Id.* at 1362.

[108]Dothard v. Rawlinson, 433 U.S. 321 (1977).

[109]EEOC Guidelines on Sex Discrimination, 29 C.F.R. § 1604 (1976).

than attempt to justify such a standard as a BFOQ. It is even more understandable why they have generally lost on both issues.

III. The Constitution as a Remedy

A. Introduction

In those cases where state action is present, it is possible to assert a claim of discrimination under the fifth and fourteenth amendments[110] of the Constitution. The concept of sex discrimination under the Constitution is no less evasive and complex than that under Title VII. As in Title VII,[111] one may think of gender-based discrimination under the Constitution as conduct that results in "dissimilar treatment for men and women who are . . . similarly situated."[112] Of course, this is not to assert that all conduct that results in men and women being treated differently on the basis of physical characteristics inextricably linked to one sex necessarily constitutes sex discrimination under the Constitution[113] or even Title

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[110]The fifth amendment is only a limitation upon the actions of the federal government, Public Util. Comm'n v. Pollak, 343 U.S. 451, 461 (1952). Although not explicitly drafted in the language of the fifth amendment, it is settled that the due process clause of the fifth amendment contains an equal protection component prohibiting the United States from invidiously discriminating between individuals or groups. Bolling v. Sharpe, 347 U.S. 497 (1954). The Supreme Court has noted that due process is more than a mere procedural guarantee. "The article is a restraint on the legislative as well as the executive and judicial powers of the government, and cannot be so construed as to leave congress free to make any process 'due process of law,' by its mere will." Murray's Lessee v. Hoboken Land & Improvement Co., 59 U.S. (18 How.) 272, 276 (1855).

[111]"Virtually all Title VII violations fit an equal protection definition of sex discrimination . . . ." Rafford v. Randle E. Ambulance Serv., Inc., 348 F. Supp. 316, 319 (S.D. Fla. 1972). Indeed, as stated by the Fifth Circuit Court of Appeals, an equal protection analysis of discrimination may be necessary in order to counter some "imaginative efforts by employers to circumvent Sec. 703." Willingham v. Macon Tel. Publishing Co., 507 F.2d 1084, 1089 (5th Cir. 1975). *See* note 63 *supra.*

[112]Frontiero v. Richardson, 411 U.S. 677, 688 (1973) (quoting Reed v. Reed, 404 U.S. 71, 77 (1971)). This definition of sex discrimination merely shifts the focus of analysis to other areas of contention—namely, whether a treatment is "dissimilar" and whether men and women are "similarly situated." the problem is exacerbated when characteristics unique to one sex are involved. *See, e.g.,* Rafford v. Randle E. Ambulance Serv., Inc., 348 F. Supp. 316, 319-20 (S.D. Fla. 1972) (no discrimination present in case of beards and moustaches since case presents situation where there can be no similarly situated individuals). As a way out of the quagmire presented by a "semantic" theory of discrimination, the courts have turned to a disparate impact rationale. *See, e.g.,* Sprogis v. United Air Lines, Inc., 444 F.2d 1194, 1198 (7th Cir. 1971), *cert. denied,* 404 U.S. 991 (1971) ("Discrimination is not to be tolerated under the guise of physical properties possessed by one sex . . . or through the unequal application of a seemingly neutral company policy.").

[113]*See, e.g.,* Geduldig v. Aiello, 417 U.S. 484 (1974).

VII.[114] However, it is possible that a specific activity may result in gender-based discrimination and yet be a permissible activity under both Title VII[115] and the Constitution.[116] Moreover, it is possible that a classification based on characteristics unique to one sex may violate Title VII but not the Constitution, since Title VII and the Constitution each require a different analysis and test for finding sex discrimination.[117] This section will focus on the analyses and tests for finding prohibited sex discrimination under the due process and equal protection clauses of the Constitution. In addition, the discussion will compare the concepts of sex discrimination under the Constitution and Title VII. Finally, the Constitution as a remedy for discrimination against unwed mothers will be considered.

B. Standard of Review

The concept of equal protection under the fourteenth amendment is essentially a pledge of protection of equal laws. Invariably, however, legislation involves classifications, and the very idea of classifying individuals for various purposes and treating some differently than others is that of inequality. Thus, the potential exists for a challenge alleging disparate treatment under the equal protection clause. Nevertheless, as stated by Professors Tussman and tenBroek: "The Constitution does not require that things different in fact be treated in law as though they were the same."[118] Accordingly, despite a demand for equality, the Supreme Court has not denied the states the right to draw classifications; but at the same time, the Court has not deferred to the legislature when such classifications are clearly arbitrary or have no rational relationship to the object or purpose of the legislation.[119]

In determining whether a particular classification is violative of equal protection, the Court has developed a two-tier approach consisting of the traditional or rational basis test and the active or strict scrutiny approach. Under the traditional or rational basis test,

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[114] *See e.g.*, General Elec. Co. v. Gilbert, 429 U.S. 125 (1976). *See also* notes 82-84 *supra* and accompanying text.

[115] *See, e.g.*, Dothard v. Rawlinson, 433 U.S. 321 (1977).

[116] *See, e.g.*, Kahn v. Shevin, 416 U.S. 351 (1974) (upholding Florida's $500 property tax deduction for widows, but not widowers); Schlesinger v. Ballard, 419 U.S. 498 (1975), *reh. denied*, 420 U.S. 966 (1975) (male Navy lieutenant dismissed from service after 9 years without promotion, but female lieutenant given 13 years before mandatory dismissal).

[117] *See* notes 153-158 *infra* and accompanying text.

[118] Tussman & tenBroek, *The Equal Protection of the Laws*, 37 CAL. L. REV. 341, 344 (1949) (citing Tigner v. Texas, 310 U.S. 141, 147 (1940)). *See also Developments in the Law—Equal Protection*, 82 HARV. L. REV. 1065 (1969).

[119] *See, e.g.*, Loving v. Virginia, 388 U.S. 1 (1967); Skinner v. Oklahoma, 316 U.S. 535 (1942).

the burden of proving that the government acted unconstitutionally rests with the plaintiff.[120] Under this standard, when a government draws classifications that affect different groups of people differently, the classifications must be "reasonable" in order to withstand a constitutional challenge.[121] As stated by the Supreme Court in *Massachusetts Board of Retirement v. Murgia*:[122] "[T]his inquiry employs a relatively relaxed standard reflecting the Court's awareness that the drawing of lines that create distinctions is peculiarly a legislative task and an unavoidable one. Perfection in making the necessary classifications is neither possible nor necessary."[123] Accordingly, in applying the traditional rational basis test, the Court has granted great leeway to the legislature in drafting classifications, and unless the legislation is "wholly unrelated" to its objective, it will likely survive an equal protection attack.[124]

Unlike the traditional rational basis test, the strict scrutiny standard is a more stringent test of determining whether government action violates the equal protection clause. If the Court determines that a statute or governmental action invades a "fundamental" right[125] or discriminates against a "suspect" class,[126]

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[120]*See, e.g.*, San Antonio Independent School Dist. v. Rodriguez, 411 U.S. 1, 40-41 (1973); Lindsley v. Natural Carbonic Gas Co., 220 U.S. 61, 78-79 (1911).

[121]A "reasonable" classification is one that includes "all persons who are similarly situated with respect to the purpose of the law." Tussman & tenBroek, *supra* note 118, at 1077. *See also* Geduldig v. Aiello, 417 U.S. 484, 496 n.20 (1974); F.S. Royster Guano Co. v. Virginia, 253 U.S. 412, 415 (1920).

[122]427 U.S. 307 (1976).

[123]*Id.* at 314.

[124]*Id.* In *Murgia*, a three-judge district court enjoined enforcement of a Massachusetts statute requiring a uniformed police officer to retire at age 50, holding that "a classification based on age 50 alone lacks a rational basis in furthering any substantial state interest." 376 F. Supp. 753, 754 (D. Mass. 1974). A divided Supreme Court, applying a traditional rational basis test, held that the statute did not violate the equal protection clause of the fourteenth amendment. The Court agreed with the district court that a rational basis test was the proper standard of review but disagreed with the lower court's determination that the age 50 classification was not rationally related to furthering a legitimate state interest. *Id.* at 312. The majority found that the age 50 criterion was not wholly unrelated to the objective of the statute and, accordingly, upheld its enforcement. *Id.* at 314.

[125]*See, e.g.*, Roe v. Wade, 410 U.S. 113 (1973) (rights of a uniquely private nature); Shapiro v. Thompson, 394 U.S. 618 (1969) (right of interstate travel); Williams v. Rhodes, 393 U.S. 23 (1968) (rights guaranteed by first amendment); Harper v. Board of Elections, 383 U.S. 663 (1966) (right to vote); Griffin v. Illinois, 351 U.S. 12 (1956) (rights with respect to criminal procedure); Skinner v. Oklahoma, 316 U.S. 535 (1942) (right to precreate). *See also Developments in the Law—Equal Protection*, 82 HARV. L. REV. 1065, 1127 (1969). Indeed, there is evidence that the Court has lost interest in recognizing further "fundamental" rights. *See* Massachusetts Bd. of Retirement v. Murgia, 427 U.S. 307 (1976) (rejecting the right to employment); San Antonio Independent School Dist. v. Rodriguez, 411 U.S. 1 (1973) (rejecting education as a fundamental right).

[126]Classifications that have been held suspect include alienage, Graham v. Richard-

the strict scrutiny standard is applied. Under this test, no presumption of constitutionality is accorded the statute, and the burden rests with the government to demonstrate that a compelling state interest exists for drawing the classification[127] and that there are no reasonable means by which to achieve the state's goals that impose a lesser limitation on the rights of the group disadvantaged by the classification.[128] In this respect, it is especially noteworthy that if a statute or government action is subject to strict scrutiny, the statute or governmental action is nearly always struck down.[129]

C. Sex Discrimination and the Constitution—Rational Basis Plus?

The Supreme Court has indicated that when gender-based challenges are presented under the equal protection clause, a "middle-tier" test will usually be applied. Such was not always the case; the Court, until recently, applied the traditional rational basis standard and repeatedly sustained legislative classifications based solely upon sex.[130] Not infrequently, the sustained classifications were based upon stereotyped notions of the proper role of women in an employment setting.[131]

A break in this line of thought came in 1971 when the Supreme Court first invalidated a statute on grounds of sex discrimination. In *Reed v. Reed*,[132] the Court, employing what at that time appeared to be a traditional rational basis test,[133] struck down an Idaho statute

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son, 403 U.S. 365 (1971); race, McLaughlin v. Florida, 379 U.S. 184 (1964); and ancestry, Oyama v. California, 332 U.S. 633 (1948).

[127]*See e.g.*, Loving v. Virginia, 388 U.S. 1, 9 (1967) ("very heavy burden of justification" placed upon state); Korematsu v. United States, 323 U.S. 214, 216 (1944) ("most rigid scrutiny").

[128]*See e.g.*, Dunn v. Blumstein, 405 U.S. 330 (1972); Loving v. Virginia, 388 U.S. 1 (1967); McLaughlin v. Florida, 379 U.S. 184 (1964).

[129]*See* Massachusetts Bd. of Retirement v. Murgia, 427 U.S. 307, 319 (1976) (Marshall, J., dissenting).

[130]*See, e.g.*, Hoyt v. Florida, 368 U.S. 57 (1961) (women not called for jury duty unless they were registered); Goesaert v. Cleary, 335 U.S. 464 (1948) (sustaining a Michigan statute that provided that no woman could obtain a bartender's license unless she was the wife or daughter of the male owner); Radice v. New York, 264 U.S. 292 (1924) (New York statute prohibiting night work by women in restaurants held valid); Muller v. Oregon, 208 U.S. 412 (1908) (upholding an Oregon statute that prohibited women from working in factory or laundry more than 10 hours per day).

[131]For example, in Muller v. Oregon, 208 U.S. 412, 421 (1908), Justice Brewer emphasized that it was obvious that a "woman's physical structure" placed her at a disadvantage in the "struggle for subsistence," and that, "as healthy mothers are essential to vigorous offspring, the physical well-being of woman becomes an object of public interest." In addition, it was noted that "woman has always been dependent upon man." *Id.*

[132]404 U.S. 71 (1971).

[133]However, in Frontiero v. Richardson, 411 U.S. 677, 684 (1973), Justice Brennan characterized *Reed* as a "departure from 'traditional' rational-basis analysis with

that provided that when two individuals are otherwise equally entitled to appointment as an administrator of an estate, the male applicant should be prefered to the female.[134] The *Reed* Court made it clear that a sex-based classification must be reasonable and must rest upon distinguishing characteristics that have a fair and substantial relation to the object of the legislation.[135]

Decisions subsequent to *Reed* suggest that the Court may be subjecting sex-based classifications to a more critical examination than is usually applied in the traditional rational basis test. In the Term following *Reed*, the Court decided *Frontiero v. Richardson.*[136] Relying on the equal protection component of the fifth amendment, the Court invalidated congressional legislation relating to military pay that allowed a male member of the uniformed services to claim his wife as a dependent without any showing of such a fact but required a female member to show that her husband was in fact dependent on her before she could make such a claim. What is important in *Frontiero* is that four justices[137] joined in holding that

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respect to sex-based classifications." Justice Powell, concurring in Craig v. Boren, 429 U.S. 190, 210 (1976) (footnote omitted), stated: "*Reed* and subsequent cases involving gender-based classifications make clear that the Court subjects such classifications to a more critical examination than is normally applied when 'fundamental' constitutional rights and 'suspect classes' are not present."

[134]404 U.S. at 72-73. The Idaho statute established 11 classes of persons that were determinative of the relative rights of competing applicants for letters of administration. One of these classes consisted of "the father or mother," and another section of the statute provided that in such cases males were to be preferred over females. IDAHO CODE §§ 15-312, 15-314 (1948).

[135]404 U.S. at 76.

[136]411 U.S. 677 (1973).

[137]Justice Brennan wrote the majority opinion and was joined by Justices Douglas, White, and Marshall. Justice Stewart, citing *Reed*, concurred in the judgment, stating that the federal statute worked an invidious discrimination in violation of the Constitution. *Id.* at 691 (Stewart, J., concurring) (citing Reed v. Reed, 404 U.S. 71 (1971)). Justices Powell, Burger, and Blackmun, also citing *Reed*, concurred in judgment but refused to hold that all classifications based on sex are inherently suspect. Justice Powell noted that it was unnecessary in the case to make such a characterization with all of the far-reaching implications of declaring sex a suspect classification. Rather, the case should be decided on the authority of *Reed*. 411 U.S. at 692 (Powell, J., concurring) (citing Reed v. Reed, 404 U.S. 71 (1971)).

It is interesting that Justice Powell argued that sex should not be declared a suspect classification, since the proposed Equal Rights Amendment, if adopted, will resolve the substance of the question. 411 U.S. at 692 (Powell J., concurring). The Amendment, now before the states for ratification, provides:

> Section 1. Equality of rights under the law shall not be denied or abridged by the United States or by any state on account of sex.
>
> Sec. 2. The Congress shall have the power to enforce, by appropriate legislation, the provisions of this article.
>
> Sec. 3. This amendment shall take effect two years after the date of ratification.

classifications based upon sex, like those based upon race, alienage, and national origin, are inherently suspect and must therefore by subjected to close judicial scrutiny.[138]

H.R. J. Res. 208 & S. J. Res. 9, 92d Cong., 1st Sess., 86 Stat. 1523 (1972).

The ERA's effect on employment has been the subject of much debate. *See, e.g.*, Brown, Emerson, Falk, & Freedman, *The Equal Rights Amendment: A Constitutional Basis for Equal Rights for Women*, 80 Yale L.J. 871 (1971); Hillman, *Sex and Employment Under the Equal Rights Amendment*, 67 Nw. L. Rev. 789 (1973); *Symposium—Equal Rights for Women: A Symposium on the Proposed Constitutional Amendment*, 6 Harv. Civ. Rights-Civ. Lib. L. Rev. 215 (1971).

As stated by Brown and her colleagues:

> The fundamental legal principle underlying the Equal Rights Amendment . . . is that the law must deal with the particular attributes of individuals, not with a classification based on the broad and impermissible attribute of sex. This principle, however, does not preclude legislation (or other official action) which regulates, takes into account, or otherwise deals with a physical characteristic unique to one sex. . . . So long as the law deals only with a characteristic found in all (or some) women but *no* men, or in all (or some) men but *no* women, it does not ignore individual characteristics found in both sexes in favor of an average based on one sex. Hence, such legislation does not, without more, violate the basic principle of the Equal Rights Amendment.

Brown, *supra* at 893. Thus, under the Equal Rights Amendment, legitimacy standards that effectively combine sanctions to women and not men who possess the status of "unwed parent" are arguably invalid under the Amendment. A priori, there are no unique physical characteristics of unwed pregnant women that would justify imposing sanctions (or witholding benefits) while unwed males who are also parents are not similarly treated.

In this regard, Brown has noted:

> Distinctions between single and married women who become pregnant will be permissible only if the same distinction is drawn between single and married men who father children. . . . A rule excluding single women who become pregnant would not thus be based on physical characteristics, but rather would rest on disapproval of extramarital pregnancy. Such standards must be applied equally to both sexes. Thus, if unmarried women are discharged for pregnancy, men shown to be fathers of children born out of wedlock would also be discharged. Even in this form such a rule would be suspect under the Amendment, because it would probably be enforced more frequently against women. A court will therefore be likely to strike down the rule despite the neutrality in its terms, because of its differential impact.

Id. at 975-76.

[138] Writing for the *Frontiero* plurality, Justice Brennan argued that the long and unfortunate history of sex discrimination was one factor warranting the treatment of sex as a suspect classification. Because both sex and race are immutable characteristics determined solely by accident of birth and because neither bears any sigificant relationship to the individual's ability to perform in or contribute to society, Brennan advocated that both classifications be subjected to strict scrutiny. Finally, even though the position of women in America has improved markedly, Brennan noted that women still face pervasive discrimination in educational institutions, in the job market, and in the political arena. 411 U.S. at 686.

Notwithstanding *Frontiero*, a majority of the Court has not declared sex a suspect classification.[139] But at the same time, the Court has not applied the traditional rational basis test to sex-based classifications; rather, the Court may be applying a "rational basis plus" standard when sex-based classifications are challenged under the equal protection clause.[140] For example, in *Craig v. Boren*,[141] the Court found that an Oklahoma law prohibiting the sale of 3.2% beer to males under the age of twenty-one and to females under the age of eighteen[142] denied eighteen- to twenty-year-old males equal protection. Reaffirming the proposition that statutory classifications that distinquish between males and females are subject to scrutiny under the equal protection clause,[143] the Court, citing *Reed*, stated: "To withstand constitutional challenge . . . classifications by gender must serve *important governmental objectives* and must be *substantially related to achievement of those objectives.*"[144]

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[139]Whether the similarities between sex and race classifications are sufficient to warrant classifying both as suspect has been the subject of much debate. *See, e.g.*, *Developments in the Law—Equal Protection*, 82 HARV. L. REV. 1065, 1173-74 n.61 (1969); Comment, *Are Sex-Based Classifications Constitutionally Suspect*, 66 NW. U.L. REV. 481 (1971).

In response to Justice Brennan, *see* note 138 *supra*, it has been argued that, unlike race, sex does not possess the qualities that have led the Court to apply strict scrutiny to classifications based on race, alienage, or national origin. *See* Brief for Appellees at 16, Reed v. Reed, 404 U.S. 71 (1971), *cited in* Frontiero v. Richardson, 411 U.S. at 683 nn.10 & 11. Racial classifications are suspect because minorities have been especially vulnerable to the attempts of the more powerful political forces seeking to deprive them of equal rights. *See* United States v. Carolene Prods., 304 U.S. 144, 152-53 n.4 (1938). On the other hand, women are not so classified because they constitute a numerical majority and are not thereby disabled from exerting their political influence. In addition, sex-based classifications, unlike those of race, are not commonly perceived as implying a stigma of inferiority and do not have a disfavored status similar to that of race-type distinctions in constitutional history. *See* Brief for Appellees at 16, Frontiero v. Richardson, 411 U.S. 677 (1973). *See also* San Antonio Independent School Dist. v. Rodriguez, 411 U.S. 1, 28 (1973) (A suspect class is one that is "saddled with such disabilities, or subjected to such a history of purposeful unequal treatment, or relegated to such a position of political powerlessness as to command extraordinary protection from the majoritarian political process.").

[140]*See, e.g.*, Stanton v. Stanton, 421 U.S. 7 (1975) (invalidating under equal protection clause state statute extending majority status to males at age 21 and females at age 18); Weinberger v. Wiesenfeld, 420 U.S. 636 (1975) (providing widows but not widowers with survivors' benefits while caring for children held violative of equal protection). *See also* the analysis in Geduldig v. Aiello, 417 U.S. 484 (1974) where the Court applied what appears to be a super-rational basis test in finding that the State of California did not violate equal protection in excluding pregnancy-type disabilities from a state disability program.

[141]429 U.S. 190 (1976).

[142]OKLA. STAT., tit. 37, §§ 241-245 (1958 & Supp. 1976).

[143]429 U.S. at 197.

[144]*Id.* (emphasis added). *See also* Califano v. Goldfarb, 430 U.S. 199 (1977), in which the Court reaffirmed this approach.

Justice Powell's concurring opinion in *Boren* is particularly noteworthy because he specifically recognized that the Court, while not treating sex as a suspect classification, nevertheless "subjects such classifications to a more critical examination than is normally applied when 'fundamental' constitutional rights and 'suspect classes' are not present."[145] As stated by Justice Powell: "[C]andor compels the recognition that the relatively deferential 'rational basis' standard of review normally applied takes on a sharper focus when we address a gender-based classification."[146]

As suggested by Justice Powell, the significance of adopting a "rational basis plus" standard is that governmental action will be subjected to a closer degree of scrutiny when gender-based classifications are drawn. The great leeway granted to the legislature in drawing classifications under the traditional rational basis test[147] will not be similarly accorded under this approach. Although precise congruity between the classification and the legislative purpose will not be required, it seems clear that in order to withstand an equal protection challenge the sex-based classification must closely serve the legislative objective.[148] No longer will sex-related legislation be struck down only if the classification is "wholly unrelated to the objective of the statute"[149]—the standard applied under a traditional basis test.

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[145]429 U.S. at 210.

[146]*Id.* n.*.

[147]*See* text accompanying notes 120-124 *supra.*

[148]In Craig v. Boren, 429 U.S. 190 (1976), the State of Oklahoma offered considerable statistics in support of its argument that its gender-based drinking age statute (prohibiting males under the age of 21 from purchasing 3.2% beer, while the age limit for females was set at 18) was substantially related to its legislative objective. *Id.* at 200-01. Based on those statistics the district court, while noting that "the case is not free from doubt," Walker v. Hall, 399 F. Supp. 1304, 1314 (W.D. Okla. 1975), *rev'd sub nom.* Craig v. Boren, 429 U.S. 190 (1976), concluded that this statistical showing substantiated "a rational basis for the legislative judgment underlying the challenged classification." *Id.* at 1307.

The Supreme Court reversed, stating that the statistics "in our view cannot support the conclusion that the gender-based distinction closely serves to achieve . . .[the traffic safety] objective." 429 U.S. at 200. The Court stated: "While such a disparity is not trivial in a statistical sense, it hardly can form the basis for employment of a gender line as a classifying device." *Id.* at 201. Indeed, Justice Stewart's concurring opinion characterized the gender-based disparity created by the statute as amounting to "total irrationality," *id.* at 215, a conclusion that is certainly questionable under a traditional rational basis test. It appears that the *Boren* Court was applying a "middle-tier" standard that is more exacting than the traditional test applied to social and economic regulation.

[149]Massachusetts Bd. of Retirement v. Murgia, 427 U.S. 307, 316 (1976).

D. Sex Discrimination under Title VII and the Constitution—A Comparison

It is important to understand the differing concepts of discrimination under Title VII and the Constitution, for at times an individual may have a cause of action under both. As indicated above, after determining that a particular statute or other governmental action classifies or otherwise discriminates between two groups of individuals, the next step in an inquiry under the equal protection clause is to examine the nature of the classification. If the classification invades a "fundamental" right or discriminates against a "suspect" class, the strict scrutiny standard will be applied.[150] Otherwise, the government need only show that classification is justified by some rational basis. If the classification involves a gender-based distinction, a more stringent showing will be necessary than a mere rational basis.[151] However, unlike the equal protection clause, Title VII does not authorize any "rationality" test. Absent the BFOQ exception,[152] the statute represents a flat and absolute prohibition against all employment discrimination on the basis of race, color, sex, religion, and national origin.

In discussing the theories of finding discrimination under Title VII (disparate treatment, disparate impact, and conditions peculiar to female physiology), cases decided under a constitutional rationale frequently provide a reasoning that is applicable to, although not necessarily dispositive of, finding discrimination under Title VII. However, this is not to assert that the analysis for finding prohibited discrimination under the Constitution can be equated with that required under Title VII. As noted by the Supreme Court in *Washington v. Davis*,[153] constitutional standards for adjudicating claims of invidious discrimination are not identical to standards applicable under Title VII. The important point here is that with respect to understanding the theories of discrimination the rationale provided by courts in constitutional cases may indeed be instructive in formulating theories of discrimination under Title VII.[154] A priori, the statutory and constitutional analysis for finding *sex* discrimination would appear to be different, especially in light of a 1976

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[150]*See* notes 125-129 *supra* and accompanying text.

[151]*See* notes 130-144 *supra* and accompanying text.

[152]*See* note 19 *supra*.

[153]426 U.S. 229, 238-39 (1976).

[154]Accordingly, as a first step in finding "discrimination" under Title VII, the courts often cite selected constitutional cases as illustrative of a disparate treatment or impact theory. This is not to assert that these cases are necessarily good law (especially after Washington v. Davis, 426 U.S. 229 (1976)) or are even dispositive of the discrimination issue.

Supreme Court decision dealing with standards for adjudicating claims of race discrimination. In *Washington v. Davis*,[155] the Supreme Court held that a personnel test that excluded four times more black than white applicants for police officer positions with the District of Columbia was not violative of equal protection solely by reason of its racially disproportionate impact. Justice White, writing for the majority,[156] stated: "We have never held that the constitutional standard for adjudicating claims of invidious racial discrimination is identical to the standards applicable under Title VII, and we decline to do so today."[157] Under *Washington*, disproportionate impact is not irrelevant, but, standing alone, it is not the sole criterion for finding invidious racial discrimination so as to trigger the rule that suspect classifications are to be subjected to strict scrutiny. Rather, a racially discriminatory purpose must be demonstrated in order to make out a cause of action under the Constitution.[158]

With respect to the issue of discriminatory purpose, Justice White noted that the discriminatory racial purpose need not necessarily "be express or appear on the face of the statute,"[159] for "an invidious discriminatory purpose may often be inferred from the totality of the relevant facts, including the fact . . . that the law bears more heavily on one race than another."[160] Once a prima facie case is made out, "the burden of proof shifts to the State to rebut the presumption of unconstitutional action by showing that permissible racially neutral selection criteria and procedures have the monochromatic result."[161]

Title VII does not require proof of discriminatory purpose; instead, the mere showing of disproportionate impact alone has been held to establish a prima facie case in Title VII review.[162] Arguably, the effect of this exclusion is to mandate a more rigorous standard under the statute than the Constitution. Focusing on the distinction, Justice White, again writing for the majority in *Washington*, noted that Title VII required a "more rigorous standard" and "more probing judicial review."[163] Accordingly, one would expect a different approach in applying constitutional standards under the equal protection clause than in cases arising under Title VII.

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[155] *Id.*

[156] Justice White wrote the opinion of the Court to which Justice Stevens filed a concurring opinion. Justices Brennan and Marshall filed a dissenting opinion.

[157] 426 U.S. at 239.

[158] *Id.*

[159] *Id.* at 241.

[160] *Id.* at 242.

[161] *Id.* at 241 (quoting Alexander v. Louisiana, 405 U.S. 625 (1972)).

[162] Griggs v. Duke Power Co., 401 U.S. 424, 432 (1971).

[163] 426 U.S. at 247.

However, as suggested by the district court in *Blake v. City of Los Angeles*,[164] if the application of Title VII standards to local and state agencies brings into play a standard more stringent than that appropriate under the equal protection clause of the fourteenth amendment,[165] serious constitutional questions arise as to the validity of that standard. In considering the proper scope of Title VII as applied to state and local governments, the *Blake* court stated:

> If Congress is seen, as in *Fitzpatrick v. Bitzer*, to have extended Title VII in implementation of the fourteenth amendment, no more stringent standard would be appropriate than that for which the fourteenth amendment calls, i.e., intent. If Congress is alternatively assumed to have acted in the exercise of its power to regulate interstate commerce, one comes to the Supreme Court's decision in *National League of Cities v. Usery*, in which the Court struck down an attempt by Congress to regulate employment decisions of state and local governments under the commerce clause powers of Congress. Without the commerce clause as an appropriate alternative basis, it would appear that Congress's extension of Title VII to state and local governments cannot supplant the intent standard of *Washington v. Davis*, with the more stringent impact standard of *Griggs v. Duke Power Co.*[166]

The district court accordingly applied the *Washington* intent standard in an action brought against the city of Los Angeles under Title VII, citing the holding of the Supreme Court in *Fitzpatrick v. Bitzer*,[167] which held that the authority for the extension of Title VII coverage to state and local governments in the 1972 amendments was the fourteenth amendment and reasoned that no more stringent a standard would be appropriate than that for which the fourteenth amendment calls.[168] As of this writing, the problem is still unresolved.

Illustrative of the analysis taken by the Court where a charge of sex discrimination is at issue is *General Electric Corp. v. Gilbert*,[169]

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[164] 15 Fair Empl. Prac. Cas. 76 (C.D. Cal. 1977).

[165] *See* Washington v. Davis, 426 U.S. 229 (1976).

[166] 15 Fair Empl. Prac. Cas. at 83 (quoting Scott v. City of Anniston, 430 F. Supp. 508, 515 (N.D. Ala. 1977)) (citations omitted).

[167] 427 U.S. 445 (1976).

[168] 15 Fair Empl. Prac. Cas. at 83. In this respect it is noteworthy that all courts have not adhered to the reasoning in *Blake*. *See, e.g.*, Dothard v. Rawlinson, 433 U.S. 321 (1977) (*Washington* intent standard not applied to the state of Alabama in a sex discrimination case argued under Title VII); Scott v. City of Anniston, 430 F. Supp. 508 (N.D. Ala. 1977) (showing of discriminatory purpose, and not just discriminatory impact, necessary to establish prima facie case of Title VII violation by state and local government); Harrington v. Vandalia-Butler Bd. of Educ., 418 F. Supp. 603 (S.D. Ohio 1976) (no requirement of proving intentional acts of discrimination under Title VII even when Title VII claim is asserted against local government).

[169] 429 U.S. 125 (1976). *See* discussion in notes 82-84 *supra* and accompanying text.

in which the Court held that it was not a violation of Title VII for an employer to exclude pregnancy disability from coverage of its general disability benefits plan. What is noteworthy in the *Gilbert* decision is the reasoning and analysis employed by the Court in arriving at the result. Justice Rehnquist, writing for the majority, applied an equal protection analysis in evaluating a claim of sex discrimination under Title VII. While recognizing that "there is no necessary inference that Congress . . . intended to incorporate into Title VII the concepts of discrimination that have evolved from court decisions construing the Equal Protection Clause,"[170] Rehnquist nevertheless stated that those decisions "are a useful starting point."[171] He reasoned that with respect to defining the term "discrimination," the constitutional cases "afford an existing body of law analyzing and discussing that term in a legal context not wholly dissimilar from the concerns which Congress manifested in enacting Title VII."[172] He then concluded that the Court's decision in *Geduldig v. Aiello*[173] was "quite relevant"[174] and "precisely in point"[175] in determining whether the pregnancy exclusion in *Gilbert* was discriminatory under Title VII.

As stated by Justices Brennan and Marshall in their dissent,[176] the implication that the fourteenth amendment standard of discrimination is identical to the Title VII standard is unacceptable, especially in light of a long line of cases and the central holding of *Washington v. Davis.* Equating the analysis of discrimination under the equal protection clause with that required under Title VII effectively changes the focus and meaning of discrimination under Title VII. To satisfy constitutional equal protection standards, discrimination need only be "rationally supportable" (or perhaps "super-rationally supportable" in the case where sex is at issue). Title VII authorizes no "rationality" test but rather prohibits all sex-based discrimination, absent a BFOQ. As indicated by one commentator, what Justice Rehnquist accomplished in *Gilbert* was "the introduction of some of the necessary, but unfortunate uncertainties of Constitutional adjudication into decisions which could and should be made straight forwardly under the statutory language without regard to the Fourteenth Amendment."[177] Fortunately, the analysis

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[170]*Id.* at 133.

[171]*Id.*

[172]*Id.*

[173]417 U.S. 484 (1974) (California's exclusion of pregnancy-related benefits from a state program did not amount to gender-based discrimination under the equal protection clause).

[174]429 U.S. at 133.

[175]*Id.* at 136.

[176]*Id.* at 146, 153-55 (Brennan & Marshall, JJ., dissenting).

[177]Edwards, *Labor Law Decisions of the Supreme Court during 1976-77: The Coming of Age of the "Burger Court,"* 95 LAB. REL. REP. (BNA) 329, 336 (1977).

employed by Justice Rehnquist in *Gilbert* has not been applied in two recent Title VII cases where gender-based discrimination was at issue.[178]

The *Gilbert* decision aside, Title VII and the equal protection clause require different formats for analyzing claims of gender-based discrimination. In addition, and analogously to claims of race discrimination, *Washington v. Davis* would appear to mandate that the plaintiff, in order to successfully assert a sex discrimination claim under the equal protection clause, must demonstrate that a "sexually discriminatory purpose" exists. Not surprisingly, the few courts that have considered the issue have invariably required a showing of "intent" when a gender-based claim is asserted under the Constitution.[179]

E. Sex Discrimination and the Constitution—The Unwed Parent Cases

When considering the issue of public employers' promulgation of rules and regulations relating to the employment of unwed parents, two major issues arise. The first issue is whether a public employer possesses the power to enact a morality standard for its employees. If so, the second issue is whether the power has been exercised consistently with the mandates of the due process and equal protection clauses. The courts considering the validity of enacting standards of morality have consistently held that the state may indeed enact rules prescribing the moral standards of its employees.[180] However, this is not to imply that legitimacy-of-birth standards are therefore permissible, since constitutional problems have inevitably arisen when legitimacy standards have been enacted and applied.

In *Andrews v. Drew Municipal Separate School District*,[181] a case subsequent to *Washington v. Davis*, a district court applied a

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[178]Nashville Gas Co. v. Satty, 98 S. Ct. 347 (1977); Dothard v. Rawlinson, 433 U.S. 321 (1977).

[179]*See* Harless v. Duck, 14 Fair Empl. Prac. Cas. 1616 (N.D. Ohio 1977) (official act not violative of § 1983 solely because it has a disproportionate impact regardless of whether it reflects a discriminatory purpose; however, evidence demonstrated that employment classification system could have no reasonable purpose other than to intentionally limit the employment opportunities available to women); United States v. City of Chicago, 14 Fair Empl. Prac. Cas. 462 (7th Cir. 1977) (evidence of intention must be established for prima facie case under Constitution; case remanded for determination whether *Washington* intent requirement for claims of racial discrimination also applies to claims of sexual discrimination); Scott v. City of Anniston, 430 F. Supp. 508 (N.D. Ala. 1977) (*Washington* intent standard applicable to all civil rights litigation brought under fourteenth amendment).

[180]*See, e.g.*, Beilan v. Board of Pub. Educ., 357 U.S. 399, 405, 408-09 (1958); Andrews v. Drew Mun. Separate School Dist., 371 F. Supp. 27 (N.D. Miss. 1973), *aff'd*, 507 F.2d 611 (5th Cir. 1975). *See also Developments in the Law—Academic Freedom*, 81 HARV. L. REV. 1045, 1096-97 (1968).

[181]371 F. Supp. 27 (N.D. Miss. 1973), *aff'd*, 507 F.2d 611 (5th Cir. 1975).

"mere rational basis" test in holding that a school board's policy against unwed parents constituted an impermissible discriminatory classification based upon sex, both inherently and as applied. *Andrews* involved two females who were otherwise qualified to be employed as teachers' aids—indeed, one had already been hired, while the second was an applicant—but were denied employment or discharged pursuant to a policy of not employing unwed parents.[182] The school board had based the offensive policy upon the following unsupported opinions: (1) That the bearing of an illegitimate child is conclusive proof of the parent's immorality or bad moral character, resulting in an improper teacher role model after whom students might pattern their lives; and (2) that the employment of a parent of an illegitimate child for instructional purposes materially contributes to the problem of schoolgirl pregnancies.[183] In addition, the defendant school board argued that when a single woman engages in premarital sexual relations, becomes pregnant, and begets an illegitimate child, she voluntarily places herself in a classification that necessarily cannot include men. Accordingly, they urged, a policy that treats unwed females differently is justified.[184]

The district court found that the policy was "constitutionally defective under the traditional, and most lenient, standard of equal protection" and had "no rational relation to the objectives ostensibly sought to be achieved by the school officials."[185] The policy's unconstitutionality stemmed from its conclusive presumption of a parent's immorality from the single fact of a child born out of wedlock.[186] Moreover, the court stated that even if a rational basis

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[182]In effect, the policy was directed solely at employees who were parents of illegitimate children. The rule would presumably not apply to all unwed parents, *i.e.*, divorced parents, a parent whose spouse is deceased, or a single parent with an adopted child. 371 F. Supp. at 29 n.3. The rule's applicability to particular school employees, such as bus drivers, maids, and janitors, was uncertain. *Id.* at 30 n.8.

[183]*Id.* at 30.

[184]*Id.* at 36.

[185]*Id.* at 31.

[186]*Id.* at 33. The court stated:

> By the rule, a parent, whether male or female, who has had such a child, would be forever precluded from employment. Thus, no consideration would be given to the subsequent marriage of the parent or to the length of time elapsed since the illegitimate birth, or to a person's reputation for good character in the community. A person could live an impeccable life, yet be barred as unfit for employment for an event, whether the result of indiscretion or not, occurring at any time in the past. . . . The rule makes no distinction between the sexual neophyte and the libertine. In short, the rule leaves no consideration for the multitudinous circumstances under which illegitimate childbirth may occur and which may have little, if any, bearing on the parent's present moral worth.

Id.

existed between the policy and the legitimate educational objectives of the school, the policy created an inherently suspect sex-based classification—single women—that could not survive strict scrutiny. The court noted that although the rule professed to be neutral by proscribing the employment of any parent, male or female, of an illegitimate child, such a rule could not possibly be applied in a neutral fashion. Indeed, under the school's policy, only unmarried females had been barred from employment due to the greater visibility of their out-of-wedlock children and pregnancies.[187] The district court also rejected the school board's argument regarding the voluntariness of the mother's out-of-wedlock classification. Relying on the *Frontiero* Court's refusal to consider a married female officer's "voluntary" decision to marry, the *Andrews* court stated that the voluntariness of inclusion in a given class was not an issue.[188]

It is important to stress that neither the *Andrews* district court nor the affirming court of appeals questioned the legitimacy of the school board's stated objectives—the creation of a scholastic environment conducive to the moral and intellectual development of the students, as well as the minimization of the number of schoolgirl pregnancies. The issue was not whether the school district possessed the power to formulate policies relating to the moral development of the students, but rather whether those policies advanced the objectives of the school board in a manner consistent with considerations of due process and equal protection. In this respect, the court of appeals held that the state's creation of an irrebuttable presumption that an unwed parent is unfit for employment is violative of the equal protection clause as well as the due process clause.[189] Moreover, the Supreme Court stated in *Schware v. Board of Bar Examiners*[190] that if a state designates some form of moral character as a criterion for bestowing a benefit or imposing a burden, it must be based on *present* moral character. Thus, unless the presumed fact of *present* immorality necessarily flows form the status of being an unwed parent, the due process clause will be violated.[191] As characterized by the district court in *Andrews*: "[S]uch a presumption is not only patently absurd, it is mischievous and prejudicial, requiring those who administer the policy to 'investigate' the parental status of school employees and prospective applicants."[192]

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[187]*Id.* at 35.

[188]*Id.* at 36 (citing Frontiero v. Richardson, 411 U.S. 677, 688 (1973)).

[189]507 F.2d at 614.

[190]353 U.S. 232 (1957).

[191]507 F.2d at 614.

[192]371 F. Supp. at 34.

The morality issue was argued in *Flores v. Secretary of Defense.*[193] In *Flores*, a female member of the United States Navy commenced an action seeking to prevent her own discharge for an unwed pregnancy on moral grounds. Despite her excellent military record, the Navy argued that her retention would necessarily imply that unwed pregnancies are condoned, which, in turn, would eventually result in a dilution of the moral standards set for women in the Navy.[194] The crux of the plaintiff's case was that the Navy took into consideration an unwed pregnancy in determining retention of a women but never took into account a man's actions in fathering children out of wedlock in determining a man's retention in the service. Thus, a different moral standard was applied to women than was applied to men, arguably creating an unjustifiable discrimination under the equal protection standard of the due process clause of the fifth amendment. Although the district court never rendered a definitive holding on the constitutional issue,[195] the court indicated in dictum that such "dual" standards of morality would not be permissible.[196]

F. Summary

The rulings in *Andrews* and *Flores*, as well as the Supreme Court's pronouncement in *Schware*, indicate that a government may not summarily withhold benefits or impose burdens *merely* because a woman is an unwed parent and is therefore considered immoral. Although never faced with the precise issue of excluding unwed parents as teachers or students,[197] the Supreme Court reiterated the

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[193]355 F. Supp. 93 (N.D. Fla. 1973).

[194]*Id.* at 94.

[195]After the suit was commenced, the Navy revised its policies so as to exclude moral character from consideration in determining retention of personnel in the service, thereby mooting the constitutional issue.

[196]355 F. Supp. at 96. *See also* Reinhardt v. Board of Educ., 6 Fair Empl. Prac. Cas. 235 (Ill. Cir. Ct. 1973), *aff'd* 19 Ill. App. 3d 481, 311 N.E.2d 710 (1974), *vacated for lack of administrative findings*, 61 Ill. 2d 101, 329 N.E.2d 218 (1975). In *Reinhardt*, the Illinois Circuit Court held that being unmarried and pregnant would not constitute "immorality" as a matter of law so as to sustain the suspension and firing of a teacher. 6 Fair Empl. Prac. Cas. at 237. Additionally, the court held that the equal protection clause of the Illinois Constitution would be violated if unmarried female teachers could be dismissed from their positions while male teachers who might be responsible for causing such pregnancies might not be dismissed. *Id.* a 238 (citing ILL. CONST. art. 1, § 18).

[197]The issue of a school district's authority to exclude a student from either class or extracurricular activities because of pregnancy or marital status has been a subject of much interest. *See generally* Goldstein, *The Scope and Sources of School Board Authority to Regulate Student Conduct and Status: A Nonconstitutional Analysis*, 117 U. PA. L. REV. 373 (1969); Comment, *Marriage, Pregnancy, and the Right to go to School*, 50 TEX. L. REV. 1196 (1972). Perry v. Grenada Mun. Separate School Dist., 300

constitutional impermissibility of using presumptions that offend traditional due process and equal protection standards in *Stanley v. Illinois*.[198] Under Illinois law, children of unmarried fathers, upon the death of their mother, were declared wards of the state without any hearing on parental fitness and without proof of neglect. The statute conclusively presumed that an unmarried father was an unsuitable and neglectful parent, and such a presumption was declared violative of the principles of both due process and equal protection in *Stanley*.[199]

Again, nothing in the Constitution forbids the formulation of reasonable standards of morality to advance a legitimate governmental interest. However, these standards may not include criteria based on stereotypical notions that an unwed parent is per se immoral. Nor may the standards result in a form of de jure or de facto discrimination. In this regard, it is noteworthy that under the standard mandated by *Washington v. Davis* for finding constitutional discrimination,[200] *Andrews* and *Flores* may still be good law. The "intent" standard of *Washington* may indeed be inferred when, as in *Flores*, a morality standard is only applied to women. Furthermore, even when an "unwed parent" rule is applied equally across the board, a form of de facto discrimination results that may still be redressed. As Justice White noted in *Washington*: "[A]n invidious discriminatory purpose may often be inferred from the totality of the relevant facts, including the fact . . . that the law bears more heavily on one . . . [class] than another."[201] The disproportionate effect of a policy of excluding unwed parents from governmental benefits, or alternatively imposing burdens because of such status, is clear. As stated by Justice Burger in *Stanley*: "In almost all cases,

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F. Supp. 748 (N.D. Miss. 1969), is representative of a majority of the holdings dealing with unwed mothers. Following the reasoning of the Supreme Court's decision in *Schware*, the *Perry* court held that a woman could not be excluded from school for the sole reason that she was an unwed mother. The court noted that lack of "moral character" is a legitimate reason for excluding a child from public education; however, considerations under the equal protection clause require that such a child must be readmitted after giving birth to the child, unless the school authorities establish that she is so deficient in moral character that her presence in the school will "taint" the education of the other students. *Id.* at 751 (citing Schware v. Board of Bar Examiners, 353 U.S. 232 (1957)).

[198]405 U.S. 645 (1972). *See also* Cleveland Bd. of Educ. v. LaFleur, 414 U.S. 632 (1974) (mandatory maternity leave policy requiring pregnant school teachers to take maternity leave at a specified length of time before delivey was declared violative of due process clause of fourteenth amendment, since it established an irrebuttable presumption concerning physical capacity of teachers to work after a given stage in pregnancy).

[199]405 U.S. at 656-58.

[200]*See* notes 150-158 *supra* and accompanying text.

[201]426 U.S. at 242.

the unwed mother is readily identifiable, generally from hospital records, and alternatively by physicians or others attending the child's birth. Unwed fathers, as a class, are not traditionally quite so easy to identify and locate."[202] Rarely, if ever, will an unwed father announce his status, especially when the consequences are the loss of benefits or the imposition of a burden. And indeed, the *Stanley* court never found a case in which a "neutral" policy was actually applied to an unwed father.

Once the intent standard of *Washington* is satisfied so as to find gender-based discrimination under the "rational basis plus" or "middle-tier" approach enunciated in *Craig v. Boren*,[203] the state will have the burden of demonstrating that the classification serves important governmental objectives and is substantially related to achievement of those objectives.[204] It is difficult to imagine a situation where a legitimacy-of-birth criterion serves an important governmental interest and, at the same time, is substantially related to the achievement of that interest. For example, the school district in *Andrews* defended its employment policy by arguing that the presence of unwed mothers in teaching positions would materially contribute to schoolgirl pregnancies. Absent any evidence, other than speculation and assertions of mere opinion, the court had little trouble in ruling that such a classification was totally without any rational basis in fact.[205]

As an alternative to attempting to justify an unwed parent rule based on a *Craig*-type analysis—*i.e.*, requiring evidence that the rule is in fact serving an important governmental objective and is substantially related to achievement of those objectives—the argument has been made that since no person has a constitutional right to public employment in the first instance, a government can subject employment to a legitimacy-of-birth criterion.[206] Cases suggest, however, that such an argument will not withstand constitutional challenge. In *Slochower v. Board of Higher Education*,[207] the Supreme Court observed that "to state that a person does not have

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[202] 405 U.S. 645, 665 (1972) (Burger, J., dissenting).

[203] 429 U.S. 190 (1976).

[204] *Id.* at 211 (Stevens, J., concurring). *See* notes 143-144 *supra* and accompanying text.

[205] 507 F.2d at 617.

[206] Wardlaw v. Austin Independent School Dist., 10 Fair Empl. Prac. Cas. 892, 895 (W.D. Tex. 1975). The leading case establishing the "privilege" doctrine for public employees is Bailey v. Richardson, 182 F.2d 46 (D.C. Cir. 1950), *aff'd*, 341 U.S. 918 (1951) (government employment not "liberty" or "property" for purposes of the due process clause). *See* K. Davis, Administrative Law Text §§ 7.11-.13 (2d ed. 1959); *Developments in the Law—Academic Freedom*, 81 Harv. L. Rev. 1045, 1077-81 (1968).

[207] 350 U.S. 551 (1956).

a constitutional right to government employment is only to say that he must comply with reasonable, lawful, and nondiscriminatory terms laid down by proper authorities."[208] Likewise, in *Keyishian v. Board of Regents*,[209] the Court stated that "the theory that public employment which may be denied altogether may be subjected to any conditions, regardless of how unreasonable, has been uniformly rejected."[210] In general, the authority of the "privilege doctrine" is waning, and it should not be allowed to justify the denial of benefits based on a capricious standard that can only effectively be applied to women.

IV. Conclusion

An individual discharged or otherwise discriminated against pursuant to a legitimacy-of-birth standard has various available options of redress. Under Title VII, discrimination in employment on the basis of sex is explicitly prohibited. The format required by the statute places the initial burden of demonstrating that a particular employment practice is discriminatory on the plaintiff. Thereafter, the burden shifts to the employer to demonstrate that the discriminatory practice is justified under the bona fide occupational qualification (BFOQ) exception. A plaintiff alleging discrimination under Title VII can readily demonstrate that a legitimacy policy is nothing more than a form of gender-based discrimination prohibited by the statute. Clearly the brunt of such a policy will be placed soley upon unmarried females. The male who sires an illegitimate child invariably escapes sanction. Accordingly, even if an employer can demonstrate that a legitimacy policy is applicable to males and females alike, in absence of evidence that males and females are equally affected once the policy is applied, plaintiff should have little difficulty sustaining a claim of sex-based discrimination. Moreover, the current standards as applied to a claim for justification under the BFOQ exception will favor the unwed plaintiff, since the exception has been given an extremely narrow construction by the EEOC and courts.

The nearly consistent rejection by the EEOC and the courts of an illegitimacy standard as an employment criterion should not be taken to imply that an employer may never legally discharge or refuse to hire an unwed pregnant female. Title VII essentially requires that if an employer is going to apply a legitimacy standard, it must be equally applied and equally effective with respect to both male and female unwed parents. A priori, such a policy will,

[208]*Id.* at 555.
[209]385 U.S. 589 (1967).
[210]*Id.* at 605-06.

however, have the certain and foreseeable impact of depriving females, but not similarly situated males, of employment opportunities. Still, an employer may indeed have a valid business interest in maintaining some public image or some standard of morality so as to warrant the use of a legitimacy standard under the BFOQ exception. However, it seems clear from the cases that a mere claim of a morality or public image interest alone will not withstand scrutiny under the current tests applied to the BFOQ defense. An employer will not be permitted to rely upon the BFOQ exception merely by citing the stereotyped characterization that unwed pregnant females as a class are immoral or detrimental to the employer's public image. Absent a BFOQ, Title VII mandates that individuals must be considered on the basis of their individual capacities to perform a specified job and not on any general stereotyped characterizations of morality as related to a legitimacy standard.

Likewise, under the equal protection clause, a plaintiff challenging a legitimacy standard as discriminatory will initially have to establish that the resulting classification is a gender-based classification. Under the standard mandated by the Supreme Court in *Washington v. Davis*, plaintiff must demonstrate that a discriminatory purpose exists in order to find discrimination in the first instance. In this regard, plaintiff should have little difficulty since an impermissible discriminatory purpose may properly be inferred from the mere enactment of a legitimacy criterion. Invariably, such a policy adversely affects females who are unwed parents while their male counterparts escape sanction.

Once plaintiff has established that the classification resulting from a legitimacy policy is a gender-based classification, under the standard applied in *Craig v. Boren*,[211] the state will have the burden of demonstrating that the classification serves important governmental interests and is substantially related to achievement of those objectives. The state may have legitimate interests in promulgating and enforcing some standard of morality. However, the cases are clear that if a state designates some form of morality as a criterion for bestowing a benefit or imposing a burden, it must be based on *present* moral character and not upon any stereotyped presumption that an unwed parent is per se immoral. Moreover, the cases indicate that the resulting standards must be equally applicable, both in terms and in effect, to males and females alike. Accordingly, under the current tests applied by the courts under Title VII and the Constitution, the use of legitimacy-of-birth standards are severely, if not altogether, limited.

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[211] 429 U.S. 190 (1976).

Entire Case Removal Under 1441(c): Toward a Unified Theory of Additional Parties and Claims in Federal Courts

*Marilyn J. Ireland**

I. Introduction

Society has become increasingly complex and individual lives increasingly interrelated as technology has provided the means for rapid communication and travel. Unfortunately, another result of these advancements is that disputes have also become more complex and less local in nature. A state court may be unable to resolve an entire dispute that crosses state lines. If the dispute is to be economically resolved in a single action, a federal court may be the only reasonable forum. In recognition of the fact that a complicated life-style produces complicated disputes, the Federal Rules of Civil Procedure contain liberal joinder provisions so that a federal court may, in a single proceeding, resolve multiple claims against multiple parties.[1] Where a dispute arises between many people interlocked in a single complicated transaction or related series of transactions, justice is also served by bringing the entire problem before a single court.

Our federal system of government may prevent the single resolution of a complex dispute in a federal court. In the United States, sovereignty is divided between the state and federal governments. Congress, by statute, has provided that certain issues should properly be left to the states.[2] Even more basic than a statute is the Constitution itself, which limits the role of the federal government, including the federal courts. The states and the federal government are sovereigns within their respective spheres—which are determined by the Constitution. The method of division is by subject matter. In article III, the Constitution enumerates the kinds of cases that a federal court may hear based upon the issue or subject matter of the dispute.[3] These powers are also subject to congressional limita-

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[1]Fed. R. Civ. P. 13 to 25.

[2]*See, e.g.*, Zahn v. International Paper Co., 414 U.S. 291 (1973) (interpreting 28 U.S.C. § 1332 (1970)).

[3]U.S. Const. art. III, § 2 provides:

> The Judicial Power shall extend to all Cases, in Law and Equity, arising under this Constitution, the Laws of the United States, and Treaties made, or which shall be made, under their Authority;—to all Cases affecting Ambassadors, other public Ministers and Consuls;—to all Cases of admiralty and

tion.[4] Issues that are not constitutionally or congressionally within the subject matter jurisdiction of the federal courts must be resolved in the state court.

Constitutional limits on federal jurisdiction make it impossible for federal courts to resolve all complex problems. However, if a federal court has the power to resolve a dispute, it may constitutionally resolve the entire case.[5] Incidental matters may be "brought along" into the federal forum. In recent decisions,[6] the United States Supreme Court has expanded the constitutional definition of a "case" so that some claims and parties secondary to an action properly before a federal court may be brought into the proceedings. The expansion of the scope of an entire federal case reflects an expansion in the scope and complexity of disputes. Unfortunately, the court's definition of the constitutional scope of "case" has evolved in a complex patchwork, without any unifying theory. To date, there is no single definition of an entire constitutional case.

Each judicial expansion of the scope of a case is isolated to a particular constitutional grant of subject matter jurisdiction. The decisions are reconcilable, but this has never been done authoritatively. One rule governs federal question cases that "arise under the Constitution, laws and treaties of the United States."[7] In *United Mine Workers v. Gibbs*,[8] the Court held that an "entire case" under this rule included all logically connected claims that arose from a common nucleus of facts:

> Pendent jurisdiction, in the sense of judicial *power*, exists whenever there is a claim "arising under [the] Constitution, the Laws of the United States, and Treaties made, or which

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> maritime Jurisdiction;—to controversies to which the United States shall be a party;—to controversies between two or more States;—between a State and Citizens of another State;—between Citizens of the same State claiming Lands under Grants of different States, and between a State, or the Citizens thereof, and foreign States, Citizens or Subjects.

[4]*See* Marbury v. Madison, 5 U.S. (1 Cranch) 137 (1803).

[5]*See* United Mine Workers v. Gibbs, 383 U.S. 715 (1966); Moore v. New York Cotton Exchange, 270 U.S. 593 (1926).

[6]*See, e.g.*, State Farm Fire & Cas. Co. v. Tashire, 386 U.S. 523 (1967); United Mine Workers v. Gibbs, 383 U.S. 715 (1966).

[7]The general grant of federal question jurisdiction is 28 U.S.C. § 1331(a) (1970), *as amended* by Act of Oct. 21, 1976, Pub. L. No. 94-574, § 2, 90 Stat. 2721:

> The district courts shall have original jurisdiction of all civil actions wherein the matter in controversy exceeds the sum or value of $10,000, exclusive of interest and costs, and arises under the Constitution, laws or treaties of the United States except that no such sum or value shall be required in any such action brought against the United States, any agency thereof, or any officer or employee thereof in his official capacity."

[8]383 U.S. 715 (1966).

shall be made, under their Authority . . ." U.S. Const., Art. III, § 2, and the relationship between that claim and the state claim permits the conclusion that the entire action before the court comprises but one constitutional "case." The federal claim must have substance sufficient to confer subject matter jurisdiction on the court. The state and federal claims must derive from a common nucleus of operative fact. But if . . . a plaintiff's claims are such that he would ordinarily be expected to try them all in one judicial proceeding, then, assuming substantiality of the federal issues, there is *power* in federal courts to hear the whole.[9]

Another base of federal subject matter jurisdiction granted to the federal courts is the power to hear diversity cases between "citizens of different states" or between a citizen of a state and foreign nationals.[10] In *State Farm Fire & Casualty Co v. Tashire*,[11] the Supreme Court considered whether "minimal diversity" is consistent with article III and held that once two adverse parties from different states are present other persons may be constitutionally brought into the proceedings. The "minimum diversity" rule of *Tashire* must be considered in the context of the case's facts. *Tashire* was an interpleader case, arising under the Federal Interpleader Act,[12] which includes not only a minimum diversity jurisdictional provision but also joinder provisions that require a relationship between the diverse claims. The adverse claims against a single fund in *Tashire* were all separate causes of action arising from an automobile accident. Each injury was a separate wrong involving a different legal right. But all injuries were interrelated factually and resulted in multiple claims against a single, limited insurance fund.

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[9]*Id.* at 725 (emphasis added) (citations omitted).

[10]The general grant of diversity jurisdiction is 28 U.S.C. § 1332(a) (1970):

The district courts shall have original jurisdiction of all civil actions where the matter in controversy exceeds the sum or value of $10,000, exclusive of interests and costs, and is between—(1) citizens of different States; (2) citizens of a State, and foreign states or citizens or subjects thereof; and (3) citizens of different States and in which foreign states or citizens or subjects thereof are additional parties.

[11]386 U.S. 523 (1967). The Court in *Tashire* did not apply 28 U.S.C. § 1332 (1970), but rather another diversity statute, 28 U.S.C. § 1335 (1970).

[12]28 U.S.C. § 1335 (1970). This statute provides:

(a) The district courts shall have original jurisdiction of any civil action of interpleader or in the nature of interpleader filed by any person, firm, or corporation, association, or society having in his or its custody or possession money or property of the value of $500 or more . . . if

(1) Two or more adverse claimants, of diverse citizenship as defined in section 1332 of this title, are claiming or may claim to be entitled to such money or property . . . .

Where the very basis of subject matter jurisdiction in federal court turns upon the fact that the main claim is between diverse citizens, it is understandable that the joinder of additional *parties* should present the primary constitutional problem. In *Tashire*, the Court held that not all parties in a diversity case need to be diverse, but it did not state any rule governing the necessary relationship between claims. Similarly, where jurisdiction is based upon the existence of a federal issue the joinder of state *claims* presents the different question. In *Gibbs*, which did not deal with the joinder of parties, the Supreme Court approved the joinder of related state claims even though the basis of federal jurisdiction was the federal nature of the dispute. What the Supreme Court has not answered are the less obvious questions. What parties may be joined as part of a state action "brought along" as part of an "entire" federal question case? How related must the claims of nondiverse parties be in order to be part of an "entire" diversity case?

If the scope of a constitutional "case" is the same regardless of the particular grant of federal subject matter jurisdiction, then *Gibbs* applies in diversity cases as well as in federal question cases and permits non-diverse parties to bring only those claims that are logically related to the main diverse claims. Furthermore, *Tashire* governs the joinder of parties in federal question cases, as well as in diversity cases. A party may constitutionally join or be joined in a federal lawsuit although his or her claim, taken alone, is not within the court's subject matter jurisdiction. Under a unified theory then, all parties may be "brought along" as secondary to the main action, but each claim against each party must meet the *Gibbs* test of relatedness.

II. The Power of the Federal Judiciary: A Unified Theory in Outline

A unified definition of the scope of a constitutional "case" for all purposes is not foreclosed by existing authority and is supported by the unified approach of 28 U.S.C. § 1441(c)[13] as drafted by Congress and applied by the courts. "Entire case" removal jurisdiction is persuasive authority for cases that are not removed to a federal court but rather originate there. There is no separate constitutional grant of removal jurisdiction. Instead, removal of a lawsuit to federal

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[13]28 U.S.C. § 1441(c) (1970) provides:

> Whenever a separate and independent claim or cause of action, which would be removable if sued upon alone, is joined with one or more otherwise nonremovable claims or causes of action, the entire case may be removed and the district court may determine all issues therein, or, in its discretion, may remand all matters not within its original jurisdiction.

See Iowa Homestead Co. v. Des Moines Navigation Co., 8 F. 97, 101 (S.D. Iowa 1881).

court by a defendant is one method of invoking the federal court's power to hear the subject. The case thus comes to the federal court indirectly, but jurisdiction arises not because of the removal, but because the subject matter of the suit may constitutionally be brought in federal court. A removal case may be an indirect means of obtaining federal question jurisdiction or diversity jurisdiction. The power of the federal court to hear a removed diversity case, for example, is based upon the identical constitutional grant that governs any other diversity case in federal court.[14]

Since removal jurisdiction is an indirect form of federal question and diversity jurisdiction, section 1441(c) provides an analytical framework from which a unified theory of additional claims and parties may be deduced. This statute covers both federal question and diversity jurisdiction. It therefore stands at a crossroad between the separately developing constitutional principles governing the scope of the federal question and diversity jurisdiction. It also contains broad statutory authority for "bringing along" parties and claims for which there are no independent bases of federal jurisdiction.

"Entire case" removal jurisdiction under section 1441(c) is only one of many federal jurisdiction rules that govern cases in which there are multiple parties and claims. Common law doctrines such as ancillarity and pendency also permit secondary matters to be litigated with the main claim. Related ancillary claims against additional parties may be "brought along," even though the added parties lack diversity.[15] Similarly, claims related to a main federal question are permitted when they meet the test of pendency.[16] Pendency and ancillarity are separate doctrines that indirectly outline the scope of a constitutional "case." A merger of these two doctrines would result if the scope of a constitutional "case" were clearly and uniformly established.[17]

A unified theory of "entire case" removal jurisdiction under section 1441(c) could help resolve open questions concerning the scope of the federal question and diversity jurisdiction of the federal courts. In *State Farm Fire & Casualty Co. v. Tashire*,[18] the Supreme

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[14]Removal jurisdiction cannot extend beyond its original source of jurisdiction. *See, e.g.*, Home Life Ins. Co. v. Dunn, 86 U.S. (19 Wall.) 214 (1874); Bushnell v. Kennedy, 76 U.S. (9 Wall.) 387 (1869).

[15]*See, e.g.*, Horton v. Liberty Mut. Ins. Co., 367 U.S. 348 (1961); Phelps v. Oaks, 117 U.S. 236 (1886).

[16]Note, *Rule 14(a) and Ancillary Jurisdiction: Plaintiff's Claim against Nondiverse Third-party Defendant*, 33 WASH. & LEE L. REV. 796 (1976); 1970 WASH. U. L.Q. 511.

[17]*See* Baker, *Toward a Relaxed View of Federal Ancillary and Pendent Jurisdiction*, 33 U. PITT. L. REV. 759 (1972). *See also* 22 U.C.L.A. L. REV. 1263 (1975).

[18]386 U.S. 523 (1967). "[T]his Court and the lower courts have concluded that Article III poses no obstacle to the legislative extension of federal jurisdiction, founded on

Court expanded the constitutional scope of diversity jurisdiction by recognizing minimal diversity as a sufficient basis for a claim in federal court. The limits of the minimal diversity rule have yet to be tested. Similarly, in *United Mine Workers v. Gibbs*,[19] the Supreme Court extended the doctrine of pendency in federal question cases, thereby opening the door to a conceptual merger of pendent and ancillary jurisdiction in the form of pendent party jurisdiction.[20] Pendent party jurisdiction may be defined as the "bringing along" of the plaintiff's related claims over parties who are not a part of the main federal lawsuit. For example, a plaintiff may raise a federal claim against one defendant and a related state claim against a second defendant. The constitutionality of original pendent party jurisdiction remains doubtful. However, the limits of minimal diversity and the constitutionality of pendent party jurisdiction have already been harmoniously resolved in removal cases.[21]

Jurisdiction over joined claims and parties has evolved separately in federal question, diversity, and removal cases. However, analytically, there is no reason to treat the constitutional grant of authority over joined claims and parties differently on the basis of original jurisdiction. Practically, differences should be dealt with through statutory interpretation and judicial discretion in order to avoid a continuation of the undue complexities now encountered in defining the constitutional power of the federal courts.

III. Added Parties: Toward a Unified Theory

In both diversity and federal question cases, the law permits the "bringing along" of some matters that, when viewed separately, would fall outside the constitutional grant of authority of the federal courts. In diversity cases, the power of the federal courts over non-diverse parties was once doubted, but it is now clearly established.[22] Section 1332,[23] the most general provision, is

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diversity, so long as any two adverse parties are not co-citizens." *Id.* at 531. *See* Bratton, *Pendent Jurisdiction in Diversity Cases—Some Doubts*, 11 San Diego L. Rev. 296, 303-04 (1974); 59 Iowa L. Rev. 179, 188 (1973); 7 Rut.-Cam. L.J. 603 (1976).

[19]383 U.S. 715 (1966).

[20]*See generally* Aldinger v. Howard, 427 U.S. 1 (1976); Philbrook v. Glodgett, 421 U.S. 707 (1975); Moor v. County of Alameda, 411 U.S. 693 (1973); Fortune, *Pendent Jurisdiction—The Problem of "Pendenting Parties,"* 34 U. Pitt. L. Rev. 1 (1972); Shakman, *The New Pendent Jurisdiction of the Federal Courts*, 20 Stan. L. Rev. 262 (1968).

[21]*See, e.g.*, Bowman v. Home Fed. Sav. & Loan Ass'n, 521 F.2d 704 (7th Cir. 1975); Northside Iron & Metal Co. v. Dobson & Johnson, Inc., 480 F.2d 798 (5th Cir. 1973); Hermann v. Braniff Airways, Inc., 308 F. Supp. 1094 (S.D.N.Y. 1969).

[22]*See* State Farm Fire & Cas. Co. v. Tashire, 386 U.S. 523 (1967).

[23]28 U.S.C. § 1332 (1970).

more limited than the constitutional grant on which it is based. In an early case, *Strawbridge v. Curtiss*,[24] the Supreme Court held that there is diversity jurisdiction under section 1332 only when each and every plaintiff resides in a state other than each and every defendant; this is the so-called rule of "complete diversity." The *Strawbridge* complete diversity rule rests on statutory construction; it is not constitutionally mandated. Section 1335,[25] another diversity statute governing interpleader, requires only that any two adverse parties be diverse. The presence of other non-diverse parties does not, constitutionally or under section 1335, preclude federal jurisdiction over the dispute. Minimum diversity as defined in section 1335 was upheld in *State Farm Fire & Casualty Co. v. Tashire*.[26] The minimum diversity rule permits non-diverse parties and their claims to be "brought along" as incidental to matters properly pending in federal court.

Even before *Tashire*, a jurisdictional concept adopted by the courts permitted resolution of related claims even if the claims brought in new parties.[27] In order to provide a single forum for adjudication of an entire controversy that arose from a single transaction, federal courts have taken jurisdiction of compulsory counterclaims, cross claims, claims against impleaded third parties, and intervenors of right.[28] The doctrine of ancillarity, recognized in *Moore v. New York Cotton Exchange*,[29] stems from an earlier line of cases in which the Court recognized the validity of federal jurisdiction over non-diverse parties whenever federal jurisdiction was necessary in order to provide an opportunity for non-diverse parties to assert their interests in the subject matter of a controversy pending in federal court.

The doctrine of ancillarity permits the court to hear an entire case even though there is no independent basis of jurisdiction over added parties or added claims. In diversity cases, *Tashire* held that

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[24]7 U.S. (3 Cranch) 267 (1806).

[25]28 U.S.C. § 1335 (1970).

[26]386 U.S. 523 (1967). *See also* Chaffee, *Interpleader in the United States*, 41 YALE L.J. 1134 (1932); Miller, *Promoting Judicial Economy Through the Extension of Interpleader to the Tortfeasor in the Mass Tort Area*, 17 WAYNE L. REV. 1241 (1971).

[27]*See* Fulton Bank v. Hozier, 267 U.S. 276, 280 (1925); Shulman & Jaegerman, *Some Jurisdictional Limitations on Federal Procedure*, 45 YALE L.J. 393 (1936); 71 HARV. L. REV. 874 (1958).

[28]*See* Horton v. Liberty Mut. Ins. Co., 367 U.S. 348 (1961) (compulsory counterclaims); Phelps v. Oaks, 117 U.S. 236 (1886) (intervention of right); Pennsylvania R.R. v. Erie Ave. Warehouse Co., 302 F.2d 843 (3d Cir. 1962) (impleader); R.M. Smythe & Co. v. Chase Nat'l Bank, 291 F.2d 721 (2d Cir. 1961) (cross-claims).

[29]270 U.S. 593 (1926). *See also* Wichita R.R. & Light Co. v. Public Utils. Comm'n, 260 U.S. 48 (1922); Phelps v. Oaks, 117 U.S. 236 (1886); Freeman v. Howe, 65 U.S. (24 How.) 450 (1860).

non-diverse parties to the original claim may also be part of an entire constitutional "case." *Tashire* can thus be seen as an extension of the doctrine of ancillarity to include original non-diverse parties as well as parties who come into the lawsuit after it is filed.

In federal question cases, another court-made extension of federal judicial power enables the court to hear non-federal aspects of the controversy. Pendent jurisdiction in federal question cases, however, evolved separately from ancillarity. In addition to a number of specific legislative grants of jurisdiction, 28 U.S.C. § 1331[30] establishes the right of a litigant to a federal forum in cases arising under federal law. *Hurn v. Oursler*[31] recognized that the power of the federal judiciary extended beyond the mere authority to decide the federal issue; it also included the right to decide other non-federal theories of recovery when they were coupled with the federal ground. In *United Mine Workers v. Gibbs*,[32] the Supreme Court refined and extended the principle of pendent jurisdiction to cover all areas of controversy between litigants whenever there is a common nucleus of operative facts between federal and non-federal claims and whenever the related claims would "ordinarily be expected" to be tried in the same proceeding.[33] The expansive interpretations of ancillary and pendent jurisdiction have begun to merge, with the "common nucleus" test of pendency stated in *Gibbs* being based on the same factors as the transactional test that governs ancillarity.[34] Under the authorities governing to date, ancillary claims may be entertained regardless of the relationship between the parties to the subsidiary claim.[35] Federal pendent claims against additional parties, termed "pendent party jurisdiction," have not yet been sanctioned by the Supreme Court.

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[30]28 U.S.C. § 1331 (1970), *as amended by* Act of Oct. 21, 1976, Pub. L. No. 94-574, §2, 90 Stat. 2721.

[31]289 U.S. 238 (1933).

> But the rule does not go so far as to permit a federal court to assume jurisdiction of a separate and distinct non-federal cause of action because it is joined in the same complaint with a federal cause of action. The distinction to be observed is between a case where two distinct grounds in support of a single cause of action are alleged only one of which presents a federal question, and a case where two separate and distinct causes of action are alleged, one only of which is federal in character.

Id. at 245-46.

[32]383 U.S. 715 (1966).

[33]*Id.* at 725.

[34]*See* note 17 *supra* and accompanying text.

[35]*See, e.g.*, Horton v. Liberty Mut. Ins. Co., 367 U.S. 348 (1961); Phelps v. Oaks, 117 U.S. 236 (1886); Pennsylvania R.R. v. Erie Ave. Warehouse Co., 302 F.2d 843 (3d Cir. 1962); R.M. Smythe & Co. v. Chase Nat'l Bank, 291 F.2d 721 (2d Cir. 1961).

In *Aldinger v. Howard*,[36] the Supreme Court was presented with the "pendent party" issue. The plaintiff stated a claim under state law for deprivation of her rights upon dismissal from her county job, as well as a federal claim under 42 U.S.C. § 1983[37] against the county and several of its officers, asserting federal jurisdiction under 28 U.S.C. § 1343.[38] Claiming that the state legislature had waived the county's defense of sovereign immunity, the plaintiff sought to assert pendent jurisdiction over the state claim and to include the claim against the county as a "pendent party" claim. The Supreme Court dismissed the claim against the county, relying primarily upon an interpretation of the particular statutes involved, stating, "[I]t would be as unwise as it would be unnecessary to lay down any sweeping pronouncement upon the existence or exercise of such [pendent party] jurisdiction. . . . Before it can be concluded that such jurisdiction exists, a federal court must satisfy itself not only that Article III permits it, but that Congress in the statutes conferring jurisdiction has not . . . negated its existence."[39]

The Court, in stating its constitutional reservations, has been unduly reticent. In section 1441(c), Congress has authorized the federal courts to adjudicate pendent party claims in removal cases. Section 1441(c) makes no distinction, such as that suggested by Justice Rehnquist in *Aldinger*, between the "bringing along" of claims and the "bringing along" of parties. It broadly states that the "entire case" may be removed. Yet, in *Barney v. Latham*,[40] the Supreme Court held that additional parties as well as additional claims might be removed under an earlier version of section 1441(c).[41] In *Barney*, the diverse controversy consisted of a request for an accounting as to land sales. The plaintiff had also joined a non-diverse party, a land company that had acquired title to certain lands without consideration and against which the plaintiff sought a

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[36]427 U.S. 1 (1976).

[37]42 U.S.C. § 1983 (1970).

[38]28 U.S.C. § 1343(3) (1970) grants jurisdiction "[t]o redress the deprivation, under color of any State law . . . of any right, privilege or immunity secured by the Constitution of the United States or by any Act of Congress providing for equal rights of citizens or of all persons within the jurisdiction of the United States."

[39]427 U.S. at 18.

[40]103 U.S. 205 (1880).

[41]Act of Mar. 3, 1875, ch. 137, § 2, 18 Stat. 470 (current version at 28 U.S.C. § 1441(c) (1970)):

> [E]ither party may remove said suit [in which there is a controversy between citizens of different States] into the circuit court of the United States . . . . And when in any suit mentioned in this section there shall be a controversy which is wholly between citizens of different States . . . then either one or more of the plaintiffs or defendants . . . may remove said suit . . . .

determination of its ownership. The Court reversed a lower court's remand of the removal petition.

Although *Barney* was a diversity case, arising under a superseded removal statute that dealt only with diversity removal of an "entire case," the current statute applies to separate and independent controversies no matter what the base of original jurisdiction may be. Additional parties may be "brought along" under section 1441(c) if the main claim is based on a federal question. In *Bowman v. Home Federal Savings & Loan Association*,[42] a class of plaintiffs sought an injunction in state court against two defendant savings and loan companies that were not fulfilling their statutory duty to provide home mortgage financing. One of the defendants was federally chartered. Federal jurisdiction over the separate and independent claim against the federally chartered defendant rested on 28 U.S.C. § 1337[43] because the claim had arisen under a congressional act relating to commerce. Because this claim could properly be brought in federal court, the federally chartered defendant exercised its option to remove under section 1441(c). The Seventh Circuit Court of Appeals upheld removal of the entire lawsuit, including the claim against the non-diverse state institution, even though there was no original subject matter jurisdiction over this defendant.[44] Thus, in the *Bowman* class action, the Seventh Circuit permitted removal of claims against an additional defendant over whom original subject matter jurisdiction was lacking.

Similarly, the related, yet separate and independent, claims of additional plaintiffs may be removed under section 1441(c). Recently, a district court upheld removal jurisdiction over the claims of additional plaintiffs in a class action suit. In *Lowenschuss v. Gulf & Western Industries, Inc.*,[45] the district court denied remand of a class action suit in which the claims of some, but not all, members of the plaintiff class met the jurisdictional amount statutorily required for diversity of citizenship. The court upheld "entire case" jurisdiction under section 1441(c) because the separate and independent claims of the named plaintiff provided a base for original jurisdiction.

The problem in *Bowman* was essentially one of pendent party jurisdiction because the additional related claim was asserted by the plaintiff against an additional defendant. The problem in

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[42]521 F.2d 704 (7th Cir. 1975).

[43]28 U.S.C. § 1337 (1970) provides in part: "The district courts shall have original jurisdiction of . . . any Act of Congress regulating commerce . . . ."

[44]521 F.2d at 706.

[45]419 F. Supp. 342 (E.D. Pa. 1976). *See* Biechele v. Norfolk & W. Ry., 309 F. Supp. 354 (N.D. Ohio 1969). *But see*, Rosack v. Volvo of America Corp., 421 F. Supp. 933 (N.D. Cal. 1976).

Lowenschuss might more properly be called ancillarity, since the claims were brought by additional plaintiffs. In both cases, the courts upheld jurisdiction over additional claims and parties, even though Bowman was based on federal question jurisdiction, while *Lowenschuss* relied on diversity jurisdiction. The similar outcomes in these cases demonstrate the constitutional irrelevance of distinctions between pendency and ancillarity and between the scope of a case that arises from a federal question rather than diversity jurisdiction. Jurisdiction in removal cases does not turn upon whether the additional party is plaintiff or defendant, nor upon the particular jurisdictional base of the independent claim, but rather upon the broad scope of the removal statute.

Lowenschuss closely paralleled *Zahn v. International Paper Co.*,[46] but reached a contrary result. *Zahn*, also a diversity case, was a class action against an industrial polluter in which some, but not all, of the plaintiff property owners met the statutory amount-in-controversy requirement. In *Zahn*, the Supreme Court denied jurisdiction over related parties and claims by statutory construction of section 1332(a) and held that the doctrine of ancillarity would not be applied to permit the "bringing along" of class members whose separate but related claims failed to meet the jurisdictional amount. Interpreting the statutory phrase "matter in controversy" to preclude aggregation of separate and district claims, the Court upheld the dismissal of those claims which failed to individually meet the statutorily required amount in controversy. In other words, *Zahn* held that the concept of ancillarity could not be applied to supply jurisdiction over those class members who did not meet the jurisdictional amount of $10,000 required by section 1332. *Lowenschuss* and *Zahn* are not reconcilable under any view of constitutional principles that make distinctions between the scope of federal question and diversity jurisdiction, between ancillary and pendent claims, or between added parties andadded claims. Rather, the contrary outcome in each case results from statutory construction.[47]

The ancillarity issue in *Zahn* was identical to the "pendent party jurisdiction" issue in *Aldinger*. In both *Zahn* and *Aldinger*, the problem was the "bringing along" of additional parties, not merely additional claims. The rejection of "entire case" jurisdiction over

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[46]414 U.S. 291 (1973). *See generally* Mattes & Mitchell, *The Trouble with Zahn: Progeny of Snyder v. Harris Further Cripples Class Actions*, 53 NEB. L. REV. 137, 140, 159, 164-65, 169, 194 (1974); Strausberg, *Class Actions and Jurisdictional Amount: Access to a Federal Forum—A Post Snyder v. Harris Analysis*, 22 AM. U. L. REV. 79 (1972); *see also* Snyder v. Harris, 394 U.S. 332 (1969).

[47]*Compare* Zahn v. International Paper Co., 414 U.S. 291 (1973), *with* Lowenschuss v. Gulf & W. Indus., Inc., 419 F. Supp. 342 (E.D. Pa. 1976).

parties in *Zahn* and *Aldinger* turned on a narrow interpretation of *original* jurisdiction statutes. Similarly, the acceptance of "entire case" jurisdiction over parties in *Bowman* and *Lowenschuss* turned on the broad statutory grant of *removal* jurisdiction under section 1441(c).[48] Since there is no direct constitutional grant of removal jurisdiction, it being rather an indirect form of original jurisdiction, the constitutional scope of removal cannot be broader than the bases of original jurisdiction from which it springs.

In view of Justice Rehnquist's reservations in *Aldinger* concerning the constitutionality of "bringing along" claims when doing so would involve new parties, the constitutionality of the removal cases might well be questioned. However, the Federal Interpleader Act provides for such jurisdiction[49] and is constitutional.[50] Removal jurisdiction statutes have contained "entire-case" provisions for many years, including the 1866 statute discussed in *Barney*.[51] The tacit acceptance of "entire-case" removal for so many years supports its constitutionality.[52]

The constitutional grant of judicial authority recognizes subject matter jurisdiction over "cases" and "controversies," not over parties.[53] Confusion arises because diversity turns upon the citizenship of the parties. However, diversity is a species of subject matter jurisdiction, not personal jurisdiction. The question is not the power of the federal court to act with respect to the parties before it, but rather, the power of the court to deal with the subject matter of the suit.

Diversity establishes jurisdiction over the claim at issue, not over the parties to the dispute. Diversity jurisdiction illustrates the supremacy of the federal government over interstate matters. The constitutional grant of diversity jurisdiction in federal courts provides a federal forum for the resolution of disputes that cross state boundaries.[54] The constitutional grant, therefore, runs to the "con-

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[48]*Cf.* Green, *Jurisdiction of U.S. District Courts in Multiple-Claim Cases*, 7 VANDERBILT L. REV. 472 (1959): "The difference between original and removal jurisdiction results from the fact that Congress conferred more of the constitutional jurisdiction when providing for removal." *Id.* at 490.

[49]*See* 28 U.S.C. § 1335 (1970).

[50]*See* State Farm Fire & Cas. Co. v. Tashire, 386 U.S. 523 (1967).

[51]Act of July 27, 1886, c. 288, 14 Stat. 306, *quoted in* Barney v. Latham, 103 U.S., at 209-10.

[52]*See* J. MOORE, COMMENTARY ON THE U.S. JUDICIAL CODE ¶ 0.03(37), at 253 (1949).

[53]For example, ancillary jurisdiction is sometimes seen as a subdivision of diversity jurisdiction, since added parties need not be diverse parties. It is equally true, however, that ancillary claims need not raise a federal issue.

[54]In part because of the heavy caseload in federal courts, diversity has been questioned as a useful statutory base of federal jurisdiction. *See* Bratton, *Diversity Jurisdiction—An Idea Whose Time Has Passed*, 51 IND. L.J. 347 (1976); Eisenberg,

troversy," not to the citizen. The *Strawbridge* rule requiring complete diversity obscured this important principle for a period of time. Implicit in *Strawbridge* was the theory that federal jurisdiction could be "destroyed" by joinder of a non-diverse party. As a constitutional principle, this theory was rejected by the Supreme Court in *Tashire.* There, the Court upheld jurisdiction over the entire lawsuit because the interpleader statute constitutionally required only minimum diversity between adverse parties.

The emphasis upon the claim rather than the parties places the constitutional principles governing diversity and federal question jurisdiction are in symmetry. The presence or absence of particular parties may be relevant in determining whether the claim is or is not within the jurisdiction of a federal court, but the jurisdiction itself attaches to the claim, not to the parties.

Under this theory, the reticence of federal courts to exercise pendent party jurisdiction seems to be without a constitutional basis. The view that diversity jurisdiction attaches to the claim accords with *Tashire*, which upheld the bringing along of parties in a diversity case. Similar logic suggests commensurate authority in federal question cases. Accordingly, section 1441(c) is not constitutionally infirm merely because it provides for entire case removal, even when this means adjudication of claims by or against parties who would not otherwise be in federal court.

IV. Added Claims: Toward a Unified Theory

Jurisdiction over an "entire case," including related claims, can also be reconciled under a unified constitutional theory regardless of the jurisdictional base of the main claim. In *United Mine Workers v. Gibbs,*[55] the Supreme Court held that there is but one constitutional "case" if the claims of the parties are interrelated and stem from a common nucleus of operative facts. However, the grant of authority in section 1441(c) contains no such limitation. It authorizes the "bringing along" of all joined claims that would not otherwise be within federal jurisdiction. The discretion of the federal judge to remand portions of the litigation makes it less likely that the constitu-

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Congressional Authority to Restrict Lower Federal Courts, 83 Yale L.J. 498, 514 (1974); Frank, *Let's Keep Diversity Jurisdiction*, 9 Forum 157 (1973). Whatever may be the outcome of this debate over a general diversity statute, in complex litigation involving many parties diversity serves a valid federal objective of assuring a national forum for cases so national in scope that no local forum can resolve the whole dispute. The specific grant of diversity jurisdiction in interpleader cases, 28 U.S.C. § 1335 (1970), may be the forerunner of other similar diversity grants so that federal courts can concentrate upon truly national disputes.

[55]383 U.S. 715 (1966).

tional limits will be approached in any particular case.[56] This discretion, however, arguably is not sufficient for resolution of the constitutionality of a removal provision that applies to unrelated as well as related claims.

One commentator, Professor Lewin, writing before *Gibbs* expanded the test of pendency, questioned the constitutionality of section 1441(c).[57] By the statute's terms, only "separate and independent" claims may be the basis of a removal to federal court. In *American Fire & Casualty Co. v. Finn*,[58] the court held that separate and independent claims means "entirely unrelated," independent claims. Lewin concluded that no claim could meet both the test of "separate and independent" and also be a part of the same constitutional "case": "[A] 'separate and independent' non-federal claim is not constitutionally within the jurisdiction of the federal courts."[59] Applying the narrow test of *Hurn v. Oursler*[60] for a constitutional "case," Lewin noted that the statute seemingly permitted removal only of unconstitutional claims:

> Between the claim held to be within the pendent jurisdiction in *Hurn v. Oursler* and the claim excluded [in *Finn*] there is room for divergence of opinion as to what other joined non-federal claims would be close enough to the federal cause of action to satisfy constitutional requirements. Nevertheless it is clear at least that some connection between the claims must exist in addition to procedural joinder. And whatever criteria be adopted, certainly the "separate and independent" claims referred to in Section 1441(c) cannot be deemed to constitute a single cause of action. For that reason the "entire case" within Section 1441(c) cannot be considered as one case within the meaning of Article III, Section 2.[61]

Lewin cannot be faulted for failing to predict the looseness of the *Gibbs* "common nucleus" test later adopted to replace *Hurn.*

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[56]*See* Duvall, *Removal—The "Separate and Independent Claim,"* 7 OKLA. L. REV. 385, 391 (1954). *See also* Lewin, *The Federal Courts' Hospitable Back Door—Removal of "Separate and Independent" Non-Federal Causes of Action*, 66 HARV. L. REV. 423, 426 (1953); Moore & VanDercreek, *Multi-Party, Multi-Claim Removal Problems: The Separate and Independent Claim Under Section 1441(c)*, 46 IOWA L. REV. 489 (1961).

[57]Lewin, *supra* note 56, at 434.

[58]207 F.2d 113 (5th Cir. 1953), *cert. denied*, 347 U.S. 912 (1954). The court held that the federal claim must be totally separate, not merely separable. The federal claim must be so independent of the other claim as to constitute a separate wrong.

[59]Lewin, *supra* note 56, at 434.

[60]289 U.S. 238 (1933).

[61]Lewin, *supra* note 56 at 434-35.

Logically, a separate claim under *Hurn* and *Finn* could still be factually related to the main claim such that one "would ordinarily be expected to try them all in one judicial proceeding." Some claims therefore, may meet both the statutory separateness test and the constitutional relatedness test. Lewin, however, did correctly recognize that section 1441(c) would be unconstitutional if applied to totally unrelated claims.[62]

Section 1441(c) provides that if a separate and independent cause of action arising under federal law is joined with a non-federal claim, defendant may remove the "entire case" to federal court. If a common nucleus of operative facts underlies both the federal and non-federal claims, no constitutional problem arises, for in *Gibbs* the Supreme Court held that such a logical connection produces only one constitutional "case." Implied in this analysis is the proposition that where two totally unrelated claims are joined, two separate constitutional "cases" exist, and federal question jurisdiction over one such "case" would not provide a sufficient constitutional basis for federal jurisdiction over the unrelated claim. Applying a narrow *Hurn* test, Lewin recognized that section 1441(c) had to be limited to a single constitutional case. If *Gibbs* marks the outside limits of a constitutional case, section 1441(c) exceeds the limits of the Constitution whenever it sanctions removal of an unrelated non-federal claim with a separate and independent federal question.[63]

Some lower federal courts have recognized this problem. Many mention, almost as if the conclusion were foregone, that the separate claims are related and therefore removable.[64] The Fifth Circuit Court of Appeals concluded that a claim may be brought along under section 1441(c) only if it arises out of the same transaction or series of transactions as the separate and independent federal cause of action with which it is joined.[65]

Other courts have justified removal of the "entire case" by

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[62] *See also* Duvall, *supra* note 56. Currie recognizes that the restrictive *Finn* test leaves little room for the operation of the doctrine of pendency under § 1441(c). In *Finn*, the separate and independent claim statutorily required for removal must meet a test of independence, while *Gibbs* creates a constitutional requirement of a common nucleus of operative facts. Few claims meet one test without also meeting the other. D. CURRIE, FEDERAL JURISDICTION 125 (1976). *See also* C. WRIGHT, A. MILLER & E. COOPER, FEDERAL PRACTICE AND PROCEDURE § 3724 (1976).

[63] *See* CURRIE, *supra* note 62, at 125; DUVALL, *supra* note 56, at 391.

[64] *See, e.g.*, Bowman v. Home Fed. Sav. & Loan Ass'n, 521 F.2d 704 (7th Cir. 1975) (a federal question case). Courts use similar language in diversity cases. *See, e.g.*, Northside Iron & Metal Co. v. Dobson & Johnson, Inc., 480 F.2d 798 (5th Cir. 1973); Hermann v. Braniff Airways, Inc., 308 F. Supp. 1094 (S.D.N.Y. 1969).

[65] *See* American Fire & Cas. Co. v. Finn, 207 F.2d 113 (5th Cir. 1953), *cert. denied*, 347 U.S. 912 (1954).

terming non-federal additional claims "pendent."[66] Strictly speaking, of course, the term "pendent" is a misnomer. Jurisdiction over the "entire case" rests not upon the common law pendency doctrine, but rather on the statutory grant under section 1441(c). If, however, the *Gibbs* definition of pendency is the same as the constitutional definition of "case or controversy," the jurisdiction principle implied in these "cases" appears clear. Section 1441(c) cannot be construed constitutionally to permit the exercise of federal question jurisdiction over a totally separate non-federal case.

The simple symmetry between pendency and section 1441(c), suggested in these lower court decisions, becomes less clear when the analysis shifts from federal question to diversity jurisdiction.[67] The addition of a non-diverse claim in a diversity case presents the same analytic difficulty as the joinder of a non-federal claim to a federal one. Because article III lists federal question and diversity jurisdiction in series, the constitutional scope of both should be construed similarly. If policy reasons are added to constitutional construction, there is a strong argument that the constitutional scope of federal question jurisdiction should be broader, not narrower, than the scope of diversity jurisdiction. After two centuries of united national government, concern as to parochial state tribunals has lessened.[68] Indeed, diversity as a general source of access to the federal courts is disfavored by reformists who seek to limit or even abolish diversity as a general grounds for federal court jurisdiction. Strangely, the minimum diversity rule stated in *Tashire* apparently opens such a broad scope for section 1441(c) "entire case" removal in diversity cases, while *Gibbs* suggests a narrower constitutional interpretation in federal question removal cases.[69] Although there is no basis in the language of the Constitution for the discrepancy between federal question and diversity entire-case removal, unless *Gibbs* applies to diversity as well as to federal question cases, the scope of diversity removal cases is currently broader than federal question removal cases. There is also no policy reason for a rule that gives a federal court less authority in a federal question case than it

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[66]*See, e.g.*, Lomax v. Armstrong Cork Co., 433 F.2d 1277 (5th Cir. 1970); Methodist Home & Hotel Corp. v. United States, 291 F. Supp. 595 (S.D.Tex. 1968).

[67]The problem of apparent lack of symmetry is discussed in 1 Barron & Holtzoff, Federal Practice and Procedure § 105 (rev. ed. C. Wright 1960). *See also* Cohen, *Problems in the Removal of a "Separate and Independent Claim or Cause of Action,"* 46 Minn. L. Rev. 1, 26, 31, 37 (1961-62).

[68]*See, e.g.*, Currie, *supra* note 62, at 114; ALI Study of the Division of Jurisdiction Between State and Federal Courts 105-08 (1969).

[69]*See* Duvall, *supra* note 56; Lewin, *supra* note 56; Moore & VanDercreek, *supra* note 56.

would have solely because the parties happened to reside in different states.

There is a need in all cases for a unified definition of the scope of a constitutional "case," or at least a definition in which federal question is not the stepchild of diversity. The apparent discrepancy is most troubling because of its obviousness in removal cases. Section 1441(c) applies an equal rule in diversity and removal cases, yet may be unconstitutionally broad in federal question cases due to *Gibbs*. Professor Wright, quite practically, concludes that minimum diversity will exist in most cases, even those that involve a federal question.[70] Professor Cohen recognized the problem and suggests one solution: "Where removal is effected under section 1441(c) on the basis of properly joined unrelated claims, removal can be justified only on the argument that the *constitutional* frontier of the pendent jurisdiction concept encompasses factually unrelated as well as related claims."[71] In an attempt to impose symmetry, Moore argues backwards from the *Tashire* diversity decision to conclude that *Gibbs* does not invalidate 1441(c) in federal question cases.[72] Moore a priori rejects the proposition that the scope of a federal question "entire case" is narrower than the scope of a diversity case. The problem, of course, is not that diversity, or even minimum diversity, may exist where there is no federal question, nor that a federal question may be present when diversity is totally lacking. Rather, the constitutional scope of both diversity and federal question cases should be the same.

The synthesis between the constitutional scope of federal question and diversity jurisdiction that logic demands is already occurring under section 1441(c). However, the courts have not broadened the definition of a federal question "entire case" to include unrelated claims. This position would undermine *Gibbs*' authority in establishing the boundaries defining a constitutional "case." Lower federal courts have been understandably reluctant to do this; instead, they appear to apply *Gibbs'* reasoning to diversity as well as federal question "entire case" removals.[73] Just as there are limits on the scope of a constitutional "case" in federal question cases, there should also be limits on diversity cases. The courts have historically relied upon the artificial complete diversity rule in *Strawbridge* as a sufficient check on the scope of a diversity case.[74]

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[70]C. WRIGHT, LAW OF FEDERAL COURTS 148 (3d ed. 1976).

[71]Cohen, *supra* note 67, at 26.

[72]1A MOORE'S FEDERAL PRACTICE ¶ 0.163[3], at 254-55 (2d ed. 1974).

[73]*See, e.g.*, Texas Employers Ins. Ass'n v. Finn, 150 F.2d 227 (5th Cir. 1945); United States v. P.J. Carlin Constr. Co., 254 F. Supp. 637, 639 (E.D.N.Y. 1966).

[74]*See* Strawbridge v. Curtiss, 7 U.S. (3 Cranch) 267 (1806).

In applying a "rational connection" test to determine which additional claims should be retained in a diversity removal cases under section 1441(c), the lower courts have refined the minimum diversity rule.[75] In *Twentieth Century Fox Film Corp. v. Taylor*,[76] decided before *Tashire*, the district court granted removal under section 1441(c) even though only one of two defendants was diverse from the plaintiff, thereby meeting the minimum diversity requirement of *Tashire*. However, rather than utilizing the broadest scope of "entire case" removal, the district court elected against such a liberal approach. Instead, it removed the separate and independent claims against the diverse party and all related claims against the non-diverse party, but it remanded an unrelated claim against the non-diverse party. Clearly, the court had the statutory discretion to remove the "entire case," but because the unrelated claim presented a different constitutional "case" for which there was no basis for federal jurisdiction, it would have been an abuse of discretion for the court to do so.

The outcome in *Twentieth Century Fox* does not undermine the minimum diversity rule, but rather, complements it. Indeed, the case was cited with approval by Justice Fortas in *Tashire*[77] in which the Court held that a non-diverse claim is not within the jurisdiction of a federal court simply because it is attached to a totally unrelated diverse claim.[78] *Tashire* dealt with joinder of parties, not joinder of claims, and conflicts with *Gibbs* only to the extent that it failed to cite an obvious limitation on the holding. The puzzling breadth of *Tashire* arises only because the Court did not resolve an issue that was not before it. Silence on the issue of joinder of claims in *Tashire* is not a holding that all such joinders are proper. This reasoning reconciles the minimum diversity rule with the *Gibbs* definition of a constitutional "case."

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[75]*See, e.g.*, Stokes v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 523 F.2d 433 (6th Cir. 1975); Northside Iron & Metal Co. v. Dobson & Johnson, Inc., 480 F.2d 798 (5th Cir. 1973).

[76]239 F. Supp. 913 (S.D.N.Y. 1965). *See also* United States Indus., Inc. v. Gregg, 348 F. Supp. 1004, 1011 (D. Del. 1972); Griebel v. J.I. Case Credit Corp., 285 F. Supp. 621, 624 (D. Minn. 1968).

[77]386 U.S. at 531 n.7.

[78]If the "entire case" is read to mean all logically related claims, as *Gibbs* suggests, a constitutionally valid interpretation of § 1441(c) will include a test of the relationship between joined claims. Since *Gibbs* is subject to increasingly liberal interpretation, this approach need not unduly limit the operation of § 1441(c). *See* Green, *Jurisdiction of U.S. District Courts in Multiple-Claim Suits*, 7 VAND. L. REV. 472, 489-93 (1954). Green concludes that the courts have construed statutes strictly, but that the article III grant itself is a liberal one. The "expectation" test of *Gibbs* appears sufficient to cover the range of cases which commentators urge should be removable. 1A MOORE'S FEDERAL PRACTICE ¶ 0.163[3], at 253-54 (2d ed. 1974); C. WRIGHT, LAW OF FEDERAL COURTS 158-59 (3d ed. 1976).

Before *Tashire*, some courts took the view that a finding of a "separable" totally diverse case was a constitutional requisite for circumventing the *Strawbridge* decision.[79] The seemingly nonsensical provision of section 1441(c) that the "entire case" can be removed only if part of it is separate and independent arose from the need, under *Strawbridge*, to achieve complete diversity as to one portion of the case. Section 1441(c) and earlier removal statutes were, indeed, drafted around the supposed constitutional limitation imposed by the complete diversity rule[80] of *Strawbridge*. The test of "separateness" of claims in *Strawbridge* differed from the much broader *Gibbs* "common nucleus of operative facts" test and more closely approximated the *Hurn* test.[81] Because the narrow test of "separate and independent" is written into the statute, most litigation and comment have centered on the scope of that test. This issue has become constitutionally relevant in diversity cases since *Tashire*. It has not been relevant in federal question cases since *Gibbs* expanded the narrow *Hurn* rule.[82]

The historical need to circumvent *Strawbridge*, embodied in section 1441(c), has resulted in varying definitions of "case" for diversity and federal question purposes. The post-*Tashire* need is to search for an inclusive definition of constitutional "case" under article III. A definition of the outer limits of the "entire case" that may be brought before a federal court under section 1441(c) would not only benefit litigants in removal cases, but could also help to clarify the meaning of *Tashire*. "Minimum diversity," in itself, is a minimal guide.

V. A Unified Theory: Some Theoretical Applications

"Entire case" jurisdiction may extend to the joinder of parties or to the joinder of claims. It may have a common law source, such as ancillarity and pendency, or it may be based on a statute, such as 28 U.S.C. § 1441(c).[83] The basis of original jurisdiction over the main claim may be federal jurisdiction or diversity. The case

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[79]*See* Lewin, *supra* note 54, at 432.

[80]*See* Currie, *supra* note 62, at 475; Cohen, *supra* note 67, at 24-25. "There may . . . be constitutional limits even to the partial diversity theory . . . . Thus it may be argued that Congress could not call disparate, *unconnected* litigation a 'case' and assert federal jurisdiction merely because of some diversity of citizenship in parties to the disconnected parts." *Id.* (emphasis in original).

[81]*See* Currie, *supra* note 62, at 123-25.

[82]*Compare* United Mine Workers v. Gibbs, 383 U.S. 715 (1966), *with* Hurn v. Oursler, 289 U.S. 238 (1933). *See also* Reeves v. Beardall, 316 U.S. 283 (1942); Moore, *supra* note 52, at § 0.03(37); Note, *UMW v. Gibbs and Pendent Jurisdiction*, 81 Harv. L. Rev. 657 (1968).

[83]28 U.S.C. § 1441(c) (1970).

may be brought originally in federal court or may be removed to federal court by the defendant if he does not reside in the forum state. Under a unified theory, the consitutionality of jurisdiction over additional claims and parties depends upon the definition of the scope of the main controversy. "Case or controversy" should be similarly defined in federal question cases and in diversity cases.

A plaintiff may constitutionally raise a federal question claim against a defendant and may add a related claim over which the court does not have original jurisdiction. Because the claim is related, there is jurisdiction over it under the unified theory and under *United Mine Workers v. Gibbs.*[84] If plaintiff raises a diverse claim in federal court against a single defendant and adds a non-diverse claim, jurisdiction over the second claim is constitutional.[85] The second claim might not meet the statutory amount in controversy,[86] but this impediment is statutory, not constitutional. The added claim meets the constitutional test of diversity and, if related to the main claim, it also meets the *Gibbs* test. *Gibbs* defines the constitutional scope of a controversy and should not be limited to federal question cases.

In both of the examples above, we may assume that the plaintiff brought the lawsuit originally in federal court. If the plaintiff had begun state proceedings instead, the defendant could have removed the case to federal court.[87] Removal jurisdiction is only constitutionally as broad as original jurisdiction.[88] A defendant can remove both the main claim and the related additional claim, but there is no jurisdiction over an unrelated claim under section 1441(c) due to the *Gibbs* limitation.

Of course, the plaintiff's added claim may itself have a constitutional base of jurisdiction, but the claim may still not be proper in federal court because of statutory or common law limitations. Federal courts are courts of limited jurisdiction. They are limited not only by the Constitution, but also by statute and judicial decisions. Ancillarity and pendency apply only to related claims. Section 1441(c) removal is not so limited.[89] The court-made ancillarity and

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[84]383 U.S. 715 (1966); *see* 28 U.S.C. § 1335 (1970). Hurn v. Oursler, 289 U.S. 238 (1933), has been expanded by *Gibbs*; Strawbridge v. Curtiss, 7 U.S. (3 Cranch) 267 (1806), has been expanded by State Farm Fire & Cas. Co. v. Tashire, 386 U.S. 523 (1967).

[85]*See* note 26 *supra* and accompanying text.

[86]28 U.S.C. § 1332 (1970).

[87]*See* notes 76-77 *supra* and accompanying text.

[88]*See* note 78 *supra* and accompanying text.

[89]28 U.S.C. § 1441(c) (1970) provides:

> Whenever a separate and independent claim or cause of action, which would be removable if sued upon alone, is joined with one or more otherwise non-

pendency doctrines need not extend to the constitutional limits of relatedness. In this sense, removal jurisdiction is broader than original jurisdiction, but not because of the Constitution.[90] Rather, the distinction is statutory. Congress could constitutionally grant original jurisdiction over additional diversity and federal question claims without regard to the amount of the claim. It merely has not chosen to do so.

Jurisdiction over added parties can also be explained by a unified constitutional theory of "entire case" jurisdiction. If all claims against all parties meet the logical relationship test of *Gibbs*, jurisdiction is proper in a federal court unless limited by statute or common law. A plaintiff may constitutionally bring related claims against two defendants, even though only one of the defendants is diverse to the plaintiff. The constitutional test of diversity is minimal diversity—that is, diversity between two or more adverse parties.[91] Due to statutory interpretation, however, the federal courts do not have original jurisdiction under section 1332 unless diversity is complete.[92] This statutory limit applies only to original, not removal, cases. Under section 1441(c), a diverse defendant can remove the "entire case," including a plaintiff's claim against a non-diverse codefendant.[93] As long as the claims against the two defendants are "separate and independent," section 1441(c) permits removal.

Pendent party jurisdiction may be subject to statutory and common law limitations, but under a unified theory it is constitutional. If plaintiff sues defendant *A*, raising a federal question, it is constitutional for a federal court to hear a related claim against defendant *B*. The two claims are so interrelated that they are actually one constitutional "case." This does not mean that a federal court has jurisdiction over pendent-party cases, because there must be a statutory or common law basis for federal jurisdiction. Section 1441(c) permits the removal of the entire case, including pendent-party claims. The Supreme Court has not recognized a statutory or

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removable claims or causes of action, the entire case may be removed and the district court may determine all issues therein, or, in its discretion, may remand all matters not otherwise within its original jurisdiction.

[90]*See* note 78 *supra*.

[91]State Farm Fire & Cas. Co. v. Tashire, 386 U.S. 523 (1967).

"[T]his Court and the lower courts have concluded that article III poses no obstacle to the legislative extension of federal jurisdiction, founded on diversity, so long as any two adverse parties are not co-citizens."

Id. at 531. *See* Bratton, *Pendent Jurisdiction in Diversity Cases—Some Doubts*, 11 San Diego L. Rev. 296, 303-04 (1974); 59 Iowa L. Rev. 179, 188 (1973); 7 Rut.-Cam. L.J. 603 (1976).

[92]Strawbridge v. Curtiss, 7 U.S. (3 Cranch) 267 (1806).

[93]*See* notes 76-77 *supra* and accompanying text.

common law grant of original pendent-party jurisdiction.[94] Congress did provide for original jurisdiction over non-diverse parties in statutory interpleader cases,[95] and the Supreme Court upheld it in *State Farm Fire & Cas. Co. v. Tashire.*[96] Similarly, if Congress were to provide for the addition of parties to federal question cases, the statute would be constitutional. Any other outcome would unevenly define "cases and controversies" under the Constitution.

A unified theory of the scope of a federal "case" permits a simple resolution of constitutional issues. Joinder of claims and parties can, for policy reasons, easily be limited by statute or by rule. Congress and the Supreme Court have the authority to limit the scope of complex litigation as needed without resorting to constitutional principles that differ due to haphazard resolution of individual cases. If the Supreme Court had intended to establish different definitions of a constitutional case for federal question and diversity purposes, it easily could have said so in *Gibbs* or *Tashire.*

VI. Conclusion

The constitutional principles governing federal question and diversity cases only *appear* to differ, with *Tashire* governing diversity jurisdiction and joinder of parties, and *Gibbs* governing federal question jurisdiction and joinder of claims. Neither case is complete in itself. Under a unified interpretation of federal jurisdiction, the basis of federal jurisdiction is not important, but whether a "case or controversy" under article III is defined consistently is important. *Tashire* governs joinder of parties, including a plaintiff's claims against "pendent parties" in federal question cases. A unified theory of federal "entire case" jurisdiction follows. Such a unified theory, in fact if not in law, already governs removal cases.

The plenary scope of "entire case" removal under section 1441(c) extends to the constitutional limits of "bringing along" matters which, viewed separately, are not within a federal court's jurisdiction. Lower courts have permitted the removal of claims, even when new parties are thereby brought before the court. Pendent party jurisdiction is not unconstitutional in removal cases.[97] Instead, in applying section 1441(c), lower federal courts have refused to "bring along" unrelated claims, even in diversity cases.[98] Section 1441(c) is thereby limited, by judicial discretion if not by constitutional principles, to a definition of "entire case" which agrees with both *Tashire* and *Gibbs.*

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[94]Aldinger v. Howard, 427 U.S. 1 (1976).

[95]28 U.S.C. § 1335 (1970).

[96]386 U.S. 523 (1967).

[97]*See* notes 40-45 *supra* and accompanying text.

[98]*See* notes 64-66 & 75 *supra* and accompanying text.

The Supreme Court left open the question of a unified theory in *Aldinger v. Howard*:[99] "[T]here is little profit in attempting to decide . . . whether there are any 'principled' differences between pendent and ancillary jurisdiction . . . ."[100] There is also little profit in leaving the doctrines in their current unprincipled state.

[99] 427 U.S. 1 (1976).
[100] *Id.* at 13.

Negotiable Instruments: The Bank Customer's Ability to Prevent Payment on Various Forms of Checks

*George Wallach**

The commercial world contains many types of checks and drafts that may be used in lieu of cash in various kinds of transactions. This includes, but is by no means limited to, the popular personal check, money orders (both bank money orders and personal money orders), cashier's checks, certified checks and traveler's checks. There are, however, just two basic types of checks in common use. The first is a check that could be called a personal check, because the bank on which the instrument is drawn has no liability on the instrument.[1] The bank has not signed or accepted this type of instrument, and in the absence of a signature or an acceptance, no person is liable on the instrument.[2] At the other extreme is the bank check, a check on which a bank is liable as either a drawer or acceptor. This class of instruments includes cashier's checks and certified checks.[3]

The ability to prevent payment on personal checks is clear, for as the next section of this Article will demonstrate, a bank customer has an absolute right to stop payment on personal checks at any time prior to the actual payment of that instrument by the bank on which it is drawn. However, the bank customer's ability to prevent payment on bank checks is another matter. Neither the Uniform Commercial Code nor the judicial opinions construing the Code are as clear about the ability of a bank customer to prevent payment on bank checks. For this reason, and because comparisons between the

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[1]Personal checks include ordinary checks drawn by a bank customer and personal money orders, which are the equivalent of one check checking accounts. Hong Kong Importers, Inc. v. American Express Co., 301 So. 2d 707 (La. Ct. of App. 1974); Note, *Personal Money Orders and Teller's Checks: Mavericks Under the UCC*, 67 Colum. L. Rev. 524, 527-28 (1967).

[2]U.C.C. §§ 3-401(1), 3-410.

[3]Cashier's checks and certified checks are the most common types of bank checks. Bank money orders are treated identically to these instruments because a bank has assumed primary liability on the instrument. United States v. Second Nat'l Bank, 502 F.2d 535 (5th Cir. 1974); Fulton Nat'l Bank v. Delco Corp., 128 Ga. App. 16, 195 S.E.2d 455 (1973); Bank of Niles v. American State Bank, 14 Ill. App. 3d 729, 303 N.E.2d 186 (1973); Bailey, *Bank Personal Money Orders as Banking Obligations*, 81 Banking L.J. 669 (1964); Comment, 67 Nw. U.L. Rev. 915, 916 (1973). Traveler's checks issued by banks are also bank obligations, and once countersigned, are negotiable instruments. Ashford v. Thom. Cook & Son, 52 Haw. 113, 471 P.2d 530 (1970); Hawkland, *American Travelers Checks*, 15 Buffalo L. Rev. 501 (1965).

ability to prevent payment on personal checks and bank checks becomes important to the discussion, the ability to prevent payment on a personal check is a natural starting point.

I. Personal Checks

The Uniform Commercial Code section that is critical to an understanding of the ability to successfully prevent payment on a personal check is section 3-413(2). The author of the check, called a drawer, promises that he will pay the amount of the instrument to any holder thereof subject only to two conditions precedent: Dishonor of the draft, and any necessary notice of dishonor or protest.[4]

A drawer of a personal check has a statutory right to stop payment of his check at any time prior to its payment by the bank on which it is drawn.[5] Payment for this purpose is defined in U.C.C. section 4-303 and includes payment in cash as well as completion of posting.[6] If the drawer of the instrument has ordered his bank to stop payment under circumstances that allow the bank a reasonable time to act upon that stop order, and the bank fails to honor the stop order, the bank may not be able to charge its customer's account for the amount of the item.[7]

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[4]The drawer's liability does not arise until after the instrument has been dishonored by the drawee bank. U.C.C. § 3-413(2). Dishonor occurs when the check is presented for payment by the holder, and payment is refused for any reason. U.C.C. § 3-507(1)(a). Notice of dishonor is the act of giving actual notice of this dishonor to the drawer. Such notice may be either oral or written. U.C.C. § 3-508(3). Protest is a formalized form of notice of dishonor. U.C.C. § 3.509. It is only required on drafts or checks drawn or payable outside the United States. U.C.C. § 3-509, Comment 1.

[5]U.C.C. § 4-403(1). The stop order must arrive at the bank in time to give the bank an opportunity to act on it before actually paying the instrument. Thus, it is not sufficient for the stop order to arrive moments before payment occurs. The bank is entitled to a reasonable lead time before the stop order is treated as having been timely. U.C.C. § 4-303(1). *See* Horner, *The Stop Payment Order,* 2 Baylor L. Rev. 275 (1950); Moore, Sussman & Brand, *Legal and Institutional Methods Applied to Orders to Stop Payment of Checks,* 42 Yale L.J. 817 (1943); Morrison & Sneed, *Bank Collections: The Stop-Payment Transaction—A Comparative Study,* 32 Tex. L. Rev. 259 (1954); Note, *Stopping Payment of Checks,* 79 Banking L.J. 185 (1962); Note, *Stop Payment and the Uniform Commercial Code,* 28 Ind. L.J. 95 (1952).

[6]U.C.C. § 303 lists five different forms of payment: Acceptance or certification of the item, payment in cash, settlement without right to revoke, completion of posting, and becoming accountable. *See also* U.C.C. § 4-213(1).

[7]The burden of establishing the fact and amount of loss from any failure of the bank to act on the stop order is on the customer. The bank's potential liability to its customer for failing to heed his instructions is greatly alleviated by the bank's right to subrogate to the position of any holder in due course of the instrument under U.C.C. § 4-407(a).

Where the customer's stop order is motivated by anything other than a "real defense" to payment, a holder in due course can enforce the instrument against the

However, the right to stop payment does not destroy the obligation of the drawer to honor his contractual obligation under section 3-413 of the U.C.C.[8] In effect, the stop order does no more than create a breach of the contractual liability that the drawer has assumed under section 3-413. The drawer has promised that he will pay the instrument to any holder, subject only to any necessary notice of dishonor or protest. If the bank has dishonored the instrument in compliance with its customer's direction that payment be stopped, both notice of dishonor and protest are excused.[9] Hence, the conditions precedent to the drawer's contractual liability become inoperative once payment has been stopped.

Ordinarily, the holder of the instrument has no rights against the bank on which the instrument is drawn.[10] The holder's sole recourse is to pursue his rights against the drawer on either the drawer's section 3-413 liability or, in some circumstances, on any underlying obligation the drawer may have to the holder.[11] The only legally recognized objections to honoring a drawer's section 3-413 liability to the holder are those defenses or claims permitted by either sections 3-305 or 3-306.[12] Which of the defenses and claims will

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drawer even though payment has been stopped. Since the stop order would not have prevented the holder in due course from ultimately collecting the amount of the instrument in full, the bank's failure to act on the stop order is considered harmless to the interests of the customer, and the bank can still charge the amount of the instrument to the customer's account. U.C.C. § 4-403, Comment 8; U.C.C. § 4-407, Comment 1. These rules parallel the pre-Code situation under the Negotiable Instruments Law. Note, *Stop Payment and the Uniform Commercial Code*, 28 Ind. L.J. 95, 97-98 (1952).

[8] 2 R. Anderson, Uniform Commercial Code § 3-413:12 (2d ed. 1971 & Supp. 1974); H. Bailey, The Law of the Bank Checks § 13.11 (4th ed. 1969 & Supp. 1975).

[9] U.C.C. § 3-511(2)(b) excuses notice of dishonor and protest to any party who has "countermanded payment" of the instrument.

[10] U.C.C. § 3-409. This is the effect of the rule that a check is not an assignment of the drawer's rights to the funds deposited in his bank but merely a direction from the bank's customer to the bank to pay the instrument.

[11] If the holder of the instrument obtained the instrument from the drawer as part of some personal transaction with the drawer, the check represents conditional payment of the debt or other obligation incurred by the drawer to the holder. U.C.C. § 3-802(1)(b) provides that delivery of a personal check suspends the duty to pay an obligation until the check is presented for payment. If the check is paid, the payment satisfies both the drawer's liability on the instrument and his liability on the "underlying" obligation. If the check is dishonored by the drawee bank, the holder of the check may seek to recover from the drawer of the check on either the drawer's obligation on the instrument or his underlying obligation.

[12] Section 3-305 contains the so-called "real" defenses: Infancy, incapacity, duress, illegality of the transaction, misrepresentation, discharge in insolvency, and any other discharge of which the holder has knowledge. Section 3-306 contains the "personal" defenses: Valid claims by any person, all defenses available in an action on a simple contract, failure of consideration, and similar defenses.

For further discussion *see* note 42 *infra*.

be available for utilization by the drawer depends upon the holder's status. If the holder of the instrument is a holder in due course,[13] only a limited number of objections, primarily those listed in section 3-305 of the Code, may be asserted.[14] If, however, the holder is not a holder in due course, section 3-306 of the Code permits the drawer to raise a broader range of objections to payment of the instrument.[15]

Thus, it is clear that the bank customer may stop payment on his personal check and on other forms of checks that are essentially equivalent to a personal check and thereby put the onus of collection of the instrument on the holder. While the bank customer may ultimately be forced to pay the instrument, he does shift the burden of enforcing the instrument to the holder.[16]

The stop order's effect is only procedural, although the importance of the procedural advantage should not be missed, as the effective stop order gives the drawer an opportunity to raise objections to payment while still in possession of the cash represented by the check.[17] Rather than collecting the amount of the personal check from the bank on which it is drawn, the holder is forced to look for payment elsewhere. If the holder is the person who dealt with the bank customer and, for example, did not provide satisfactory goods or services, this holder will be tempted to negotiate for a reasonable settlement with the drawer. Even if the holder is a holder in due course who could collect on the instrument in spite of the drawer's objection to payment, the holder might choose to return the instru-

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[13]A holder in due course is a holder who satisfies the requirements of U.C.C. § 3-302(1). In addition to satisfying the three requirements of that subsection, the person in possession of the instrument must also be a holder. A holder is defined by U.C.C. § 1-201(20) as a person in possession of a negotiable instrument issued to him, indorsed to him or his order, or to bearer or in blank.

[14]In some situations, a payee of an instrument will qualify as a holder in due course. U.C.C. § 3-302(2). However, the payee who qualifies as a holder in due course is ordinarily still subject to the drawer's personal defenses, as a non-holder in due course would be. Only holders in due course who have "not dealt" with the drawer take free of the drawer's personal defenses. U.C.C. § 3-305(2). The subject of real and personal defenses is treated in greater detail in the text accompanying note 41 *infra*.

[15]Non-holders in due course take subject to the drawer's personal defenses as well as his real defenses. Such holders also take subject to competing claims of ownership to the instrument asserted by any person, while holders in due course take free of all such claims. *Compare* U.C.C. § 3-306 *with* U.C.C. § 3-305(1). The subject of claims is treated in greater detail in the text accompanying note 40 *infra*.

[16]The holder may sue the drawer to collect on the instrument. If the drawer establishes any type of defense to the payment of the instrument, the holder must then establish that he is a holder in due course who would take free of that type of defense in order to collect the full amount of the instrument. U.C.C. § 3-307(3).

[17]Note, *Blocking Payment on a Certified, Cashier's or Bank Check*, 73 MICH. L. REV. 424 (1974).

ment to the payee with whom the bank customer initially dealt, collect from the payee on his indorser's contract,[18] and leave the payee of the instrument in a position where he must seek to collect from the bank customer who wrote the check, subject to the ability of that bank customer to raise objections to payment.

II. Bank Checks

A corresponding ability to prevent payment on a bank check is not as clearly spelled out in the Code. Judicial opinions, while generally reaching the correct result, are not as well-reasoned as the decisions discussing the rights and liabilities of the parties on a personal check. This is probably due to three interrelated factors: (1) Less litigation has been generated in bank check situations, (2) the Code itself is more ambiguous about the intended rules, and (3) the relationships involved are more numerous and more complex.

A. Certified Check

The two types of bank checks that are most commonly used are the certified check and the cashier's check. The U.C.C deals with certified checks in greater detail than cashier's checks. A certified check is a personal check drawn by the customer of a bank on an account he maintains at the bank on which the bank has stamped a formal certification. The certification acts as an acceptance of the instrument by the bank.[19] Acceptance is defined to be a drawee's (in this case the bank's) signed engagement to honor the check in the form in which it was presented for certification.[20]

Section 3-413 makes an acceptor's liability essentially equivalent to that of a drawer of a personal check. The drawer's obligation on a personal check does not become an absolute obligation until the prerequisite notice of dishonor and protest are satisfied. However, where the drawer has stopped payment, as previously pointed out, these prerequisites are excused.[21] Thus, the nature of a certifying bank's liability is, as a practical matter, equivalent to that of a drawer of a personal check who has stopped payment on the instrument. The U.C.C. goes on to further define the various rights and liabilities of the parties to a certified check,[22] and clearly provides

[18]Under U.C.C. § 3-414(1), the indorser promises, upon dishonor, to pay the amount of the instrument to subsequent holders.

[19]U.C.C. § 3-411(1).

[20]U.C.C. § 3-410.

[21]*See* note 9 *supra* and accompanying text.

[22]When the drawer of a personal check has had it certified, the drawer remains liable on the instrument. U.C.C. § 3-411, Comment 1. However, if a holder obtains the certification, the drawer is discharged from his obligation on the instrument. U.C.C. § 3-411(1). Discharge on the instrument discharges the drawer's liability on the underlying obligation. U.C.C. § 3-802.

These rules, which make the drawer's discharge on the instrument dependent upon who procures the certification, are identical to the rules contained in the

that once a check has been certified the drawer of the check loses his ability to stop payment on the instrument.[23]

B. Cashiers' Checks

The Uniform Commercial Code has very little to say about cashiers' checks.[24] A cashier's check is an instrument drawn by a bank upon itself and signed by an authorized agent of the bank, ordinarily the cashier or an officer of the bank.[25] The most common analysis of the liability of the bank on a cashier's check is that the bank has assumed an acceptor's liability on the instrument through the mere act of issuing the instrument.[26] It has also been suggested

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Negotiable Instruments Law. Roberts & Morris, *The Effect of a Stop Payment Order on a Certified Check*, 5 Wyo. L.J. 170, 172-73 (1950).

[23]U.C.C. § 4-303(1)(a). This was not always the rule. Under the Negotiable Instruments Law, the generally accepted view was that payment could not be stopped if the holder had obtained the certification, but it could be stopped if the drawer had obtained the certification. Roberts & Morris, *supra* note 21, at 174-78.

The judicial opinions which established that payment could be stopped on a check certified at the request of the drawer when beyond this simple rule to create a body of law that has continued to plague more recent opinions.

Many of the opinions which recognized this right to stop payment suggested that the ability to stop payment would be lost if the drawer's objection to payment was a mere defense, as opposed to a claim of ownership, and the holder was a holder in due course. *See, e.g.*, Sutter v. Security Trust Co., 95 N.J. Eq. 44, 122 A. 381 (1923), *aff'd*, 96 N.J. Eq. 644, 126 A. 435 (1924); Welch v. Bank of Manhattan Co., 264 App. Div. 906, 35 N.Y.S.2d 894 (1942); Horner, *supra* note 5, at 278-79.

These opinions thus created the impression that the ability to successfully stop payment requires consideration of the nature of the objection to payment and the status of the holder. These questions are ones a bank would have great difficulty resolving prior to deciding whether to honor a customer's request to stop payment. The U.C.C. makes the right to stop payment a absolute one. The nature of the objection to payment and the status of the holder only become relevant when the holder later seeks to collect on the instrument from a party to the instrument. *See* U.C.C. § 4-403, Comment 8.

However, courts occasionally continue to insist on examining the nature of the objection to payment and the status of the holder in determining questions of the right to stop payment on a negotiable instrument. *See, e.g.*, Leo Syntax Auto Sales, Inc. v. Peoples Bank & Sav. Co., 35 Ohio Op. 2d 330, 215 N.E.2d 68 (C.P. Ohio 1965).

[24]The term is not defined in the Uniform Commercial Code and is found in only one section of the Code, § 4-211. Maggs, *The Construction of a Concordance to the Uniform Commercial Code*, 1974 U. Ill. L. F. 7,21.

[25]TPO Inc. v. FDIC, 487 F.2d 131, 135 (3d Cir. 1973); Pennsylvania v. Curtiss Nat'l Bank, 427 F.2d 395, 398 (5th Cir. 1970); State *ex rel.* Chan Siew Lai v. Powell, 536 S.W.2d 14, 16 (Mo. 1976); National Newark & Essex Bank v. Giordano, 111 N.J. Super. 347, 350, 268 A.2d 327, 328 (1970).

[26]Swiss Credit Bank v. Virginia Nat'l Bank, 538 F.2d 587 (4th Cir. 1976); Munson v. American Nat'l Bank & Trust Co., 484 F.2d 620, 623-24 (7th Cir. 1973); Pennslyvania v. Curtiss Nat'l Bank, 427 F.2d 395, 398 (5th Cir. 1970); Banco Ganaderoy Agricola v. Society Nat'l Bank, 418 F. Supp. 520 (N.D. Ohio 1976); Kaufman v. Chase Manhattan Bank, 370 F. Supp. 276 (S.D.N.Y. 1973); Meador v. Ranchmart State Bank, 213 Kan. 372, 517 P.2d 123 (1973); State *ex rel.* Chan Siew Lai v. Powell, 536 S.W.2d 14, 16 (Mo. 1976); Wertz v. Richardson Heights Bank & Trust, 495 S.W.2d 572, 574 (Tex. 1973).

that the instrument has been accepted by the bank as a result of the act of the cashier signing as drawer,[27] or that a cashier's check is equivalent to a note under section 3-118 of the Code.[28] Under this latter analysis, the bank is treated as a maker,[29] and a maker's liability is identical to that of an acceptor.[30]

In certified check situations, it is perfectly clear that the customer of the bank has lost his ability to stop payment once the instrument has been certified. However, while consistency may be desirable, the conclusion that payment may not be stopped on a cashier's check is not as clearly dictated by anything contained within the U.C.C. itself.

Those authorities who analyze the cashier's check situation as one involving an instrument that has been accepted, either through the act of issuance, or a bank officer's act in signing it, or both, suggest that the right to stop payment is lost because of section 4-303 of the Code. This section provides that a stop order arrives too late to bind the bank if it does not arrive within a reasonable time before the bank accepts an instrument.[31] Other authorities suggest that the bank customer who has purchased the cashier's check from his bank is not a "customer" within the meaning of section 4-402 of the Code,[32] the section which establishes the right to stop payment. Whatever the chosen manner of analysis, it is clear that the drawer of the certified check or the purchaser of a cashier's does not have the ability to stop payment on the instrument.[33]

C. Dishonor by the Bank

The mere fact that the drawer of the certified check or purchaser of a cashier's check cannot stop payment is not the end of the

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[27]National Newark & Essex Bank v. Giordano, 111 N.J. Super. 347, 350, 268 A.2d 327, 329 (1970).

[28]TPO Inc. v. FDIC, 487 F.2d 131, 135-36 (3d Cir. 1973); Banco Ganadero y Agricola v. Society Nat'l Bank, 418 F. Supp. 520, 523-24 (N.D. Ohio 1976).

[29]Although the term "maker" is used with great frequency in the Uniform Commercial Code, it is not defined.

[30]U.C.C. § 3-413(1).

[31]Under U.C.C. § 4-303(1)(a), the stop order is not timely unless it arrives a reasonable time before the bank has accepted or paid the check. Issuance of a cashier's check operates as an acceptance of the cashier's check, and thus, payment cannot be stopped on a cashier's check once it has been issued. Pennsylvania v. Curtiss Nat'l Bank, 427 F.2d 395, 399 (5th Cir. 1970); Banco Ganaderoy Argicola v. Society Nat'l Bank, 418 F. Supp. 520, 526 (N.D. Ohio 1976); National Newark & Essex Bank v. Giordano, 111 N.J. Super. 347, 351, 268 A.2d 327, 329 (1970); Wertz v. Richardson Heights Bank & Trust, 495 S.W.2d 572, 574 (Tex. 1973); U.C.C. § 4-213(1).

[32]National Newark & Essex Bank v. Giordano, 111 N.J. Super. 347, 352, 268 A.2d 327, 329 (1970); Wertz v. Richardson Heights Bank & Trust, 495 S.W.2d 572, 574 (Tex. 1973).

[33]Nor may the issuing bank stop payment on either type of instrument. The bank is not a "customer" with a right to stop payment under U.C.C. § 4-403. The bank can-

inquiry. On either type of instrument, the bank's liability is primary in nature, as that term is used by those who deal with the U.C.C.[34] That is, the bank has an independent and direct obligation to the holder to pay the instrument. This obligation is essentially contractual in nature, or perhaps more accurately it is a voluntarily assumed obligation, the legal implications of which are described in section 3-413 of the Code. The bank can, should it choose to, breach its contractual liability and refuse to pay the instrument, as there is

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not claim to be its own customer. Kaufman v. Chase Manhattan Bank, 370 F. Supp. 276 (S.D.N.Y. 1973).

Banks do draw checks on other banks at which they maintain accounts. Savings banks maintain checking accounts at commercial banks at least in part so that they will be able to give their customers official looking checks to use. Generally, savings banks do not offer checking accounts to their customers and hence cannot certify checks for customers; nor do savings banks issue cashier's checks. Instead, the savings bank draws a check on an account it maintains at a commercial bank and gives this check to its customer to use in his transaction. This type of check is usually called a teller's check. The bank which issues this check, whether it be a savings or commercial bank, is a customer of the commercial bank on which the check is drawn, and has a right to stop payment under U.C.C. § 4-403.

Several courts have concluded that payment may not be stopped on this type of instrument. *See, e.g.*, Ruskin v. Central Fed. Sav. & Loan Ass'n, 3 U.C.C. REP. 150 (Sup. Ct. N.Y. 1966); Malphrus v. Home Sav. Bank, 44 Misc. 2d 705, 254 N.Y.S.2d 980 (Albany County Ct. 1965).

There is at least one opinion permitting payment to be stopped. Fulton Nat'l Bank v. Delco Corp., 128 Ga. App. 16, 195 S.E.2d 455 (1973). Note, *Personal Money Orders and Teller's Checks: Mavericks Under the UCC*, 67 COLUM. L. REV. 524, 540-43 (1967); *See, Uniform Commercial Code Commentary*, 8 B.C. INDUS. & COM. L. REV. 260, 262-64 (1967).

However, once payment is stopped, the analysis of the ability of the drawing bank's customer to prevent a holder from collecting from the drawing bank on its drawer's contract is identical to that suggested later in the text when a cashier's check or certified check is involved. Benson, *Stop Payment of Cashier's Checks and Bank Drafts Under the Uniform Commercial Code*, 2 OHIO N.L. REV. 445, 459-60 (1975).

[34]Under the U.C.C., parties to a negotiable instrument who may be called upon to pay the instrument have either primary or secondary liability. Primary parties have two basic characteristics: They are the parties a holder will look to for payment first, and their liability is not subject to conditions precedent, other than presentment for payment. Makers of notes and acceptors have primary liability under U.C.C. § 3-413. Secondary parties are not liable until conditions precedent are satisfied. Indorsers are the principal example of secondary parties. Their liability does not arise until after a primary party has dishonored the instrument and the indorser has received notice of dishonor and protest. U.C.C. § 3-414.

Drawers do not fit neatly into either class. Their liability appears to be secondary, since holders look to the drawee first for payment, and the drawer's liability is subject to the same conditions precedent as is an indorser's. U.C.C. § 3-413(2). However, the drawee has no liability on the instrument, and viewing the drawer's liability as secondary would produce a situation where there is no party with primary liability. Nevertheless, the drawer's liability is generally referred to as being "secondary" under U.C.C. § 3-413. Comment, *Adverse Claims Under the Uniform Commercial Code: A Survey and Proposals*, 65 YALE L.J. 807, 818 n.50 (1956).

nothing in the Code which prevents the bank from doing so. Banks can and occasionally will refuse to pay on an instrument either to promote their own self interests[35] or to acommodate a dissatisfied customer who wants to see payment prevented.

The bank, having breached its contractual obligation as maker or acceptor of the instrument, is now certain to be sued by the holder. When the bank has dishonored the instrument to accommodate its customer, rather than to protect its own interests,[36] the bank must seek to utilize its customer's basis for objection to payment to absolve itself from its own contractual liability on the bank check. At common law, this attempt to utilize the bank customer's objections to payment was known as *jus tertii*.[37]

There are two variations of this situation. In the first situation, the bank is attempting to utilize its customer's objection to payment without the customer's presence as a party to the lawsuit brought by the holder of the instrument; in the second, and more common situation, the bank's customer will be a party to the lawsuit and may also have agreed to indemnify the bank for the expenses of

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[35]Such situations arise when: (1) The bank has been defrauded into issuing or certifying the instrument, TPO Inc. v. FDIC, 487 F.2d 131 (3d Cir. 1973); Rockland Trust Co. v. South Shore Nat'l Bank, 366 Mass. 74, 314 N.E.2d 438 (1974); Mid-Continent Nat'l Bank v. Bank of Independence, 523 S.W.2d 569 (Ct. App. Mo. 1975), (2) There has been a failure of consideration because (a) the bank has issued or certified the instrument in exchange for an instrument on which payment has been stopped, Munson v. American Nat'l Bank & Trust Co., 484 F.2d 620 (7th Cir. 1973); Citizens & S. Nat'l Bank v. Youngblood, 135 Ga. App. 638, 219 S.E.2d 172 (1975); Wertz v. Richardson Heights Bank & Trust, 495 S.W.2d 572 (Tex. 1973), or (b) the bank has issued or certified the instrument in exchange for an instrument that has been dishonored, generally because it was drawn against insufficient funds, Wilmington Trust Co. v. Delaware Auto Sales, 271 A.2d 41 (Del. 1970); Tropicana Pools, Inc. v. First Nat'l Bank, 206 So. 2d 48 (Dist. Ct. App. Fla. 1968), or (3) the bank is owed a debt by the purchaser of the instrument and desires a set-off against the funds represented by the unpaid cashier's or certified check. Swiss Credit Bank v. Virginia Nat'l Bank, 538 F.2d 587 (4th Cir. 1976); Central Bank & Trust Co. v. First N.W. Bank, 332 F. Supp. 1166 (E.D. Mo. 1971).

[36]In these situations, the bank's customer is not even involved in the dispute. The bank may assert the very same claims and defenses that a drawer of a personal check could assert in the same situation, and the list of available claims and defenses depends on whether the holder of the instrument is a holder in due course or not.

If the holder of the instrument is a holder in due course, the bank must have a "real" defense of its own in order to avoid liability as a primary party to the instrument. Central Bank & Trust Co. v. First N.W. Bank, 332 F. Supp. 1166 (E.D. Mo. 1971); Citizens & S. Nat'l Bank v. Youngblood, 135 Ga. App. 638, 219 S.E.2d 172 (1975).

If, however, the holder is not a holder in due course, the bank can assert all of its claims and defenses. TPO Inc. v. FDIC, 487 F.2d 131 (3d Cir. 1973); Pennsylvania v. Curtiss Nat'l Bank, 427 F.2d 395, 399 (5th Cir. 1970); Rockland Trust Co. v. South Shore Nat'l Bank, 366 Mass. 74, 314 N.E.2d 438 (1974); Mid-Continent Nat'l Bank v. Bank of Independence, 523 S.W.2d 569 (Ct. App. Mo. 1975).

[37]*Jus tertii* is defined as "[t]he right of a third party." BLACK'S LAW DICTIONARY 1000 (rev. 4th ed. 1968).

defending the holder's claim. While the bank may be willing to accommodate its customer, it would understandably be reluctant to do so if it would be forced to bear the expense and burden of defending a lawsuit brought by the holder. Hence, banks usually demand and get indemnification agreements from their customers[38] and expect that the customer will assume the burden of defending the lawsuit that is almost certain to be brought by the holder of the instrument.

D. Bank Defenses

The question now becomes what kinds of matters may properly be brought to the court's attention as appropriate grounds for absolving the bank from its contractual obligation upon the instrument. Resolution of this problem depends upon several variables. The important variables are: (1) Whether the objection to payment is a claim or a defense; (2) whether the claim or defense is a first-party or third-party claim or defense; and (3) whether the holder of the bank check is a mere holder, or a holder in due course.

1. Claims and Defenses.—The law of negotiable instruments (as it developed at common law, under the Negotiable Instruments Law, and finally, at least for the time being, under Uniform Commercial Code) has generally drawn significant distinctions between legal claims of ownership, equitable claims of ownership, and defenses to payment.[39]

Legal claims of ownership to a negotiable instrument arise most frequently, if not exclusively, from the theft of the instrument.[40] Equitable claims of ownership arise when the owner of the instrument has voluntarily parted with possession of the instrument under circumstances such that an equitable right to the return of the instrument is recognized. The most commonly recognized situation of this type occurs when the owner has been defrauded into parting with the instrument.[41]

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[38]Comment, 67 Nw. U.L. Rev. 915, 928 (1973).

[39]Britton, *Defenses, Claims Of Ownership And Equities—A Comparison Of The Provisions Of The Negotiable Instruments Law With Corresponding Provisions Of Article 3 Of The Proposed Commercial Code*, 7 Hastings L.J. 1, 20-26 (1955); Chafee, *Rights in Overdue Paper*, 31 Harv. L. Rev. 1104, 1109-19 (1918).

[40]Britton, *supra* note 39, at 25. Theft, and the subsequent forgery of order paper always gives rise to an adverse claim of title on the part of the true owner. Theft of bearer paper also gives rise to adverse title claims enforceable so long as the thief retains the negotiable instrument, but the title claim is lost once a holder in due course obtains the instrument. The concept that permits a thief's defective title in bearer paper to ripen into a good title in the hands of a transferee who qualifies as a holder in due course is one of the most critical features of the law of negotiable instruments. This concept has its genesis in Peacock v. Rhodes, 97 Eng. Rep. 402 (K.B. 1781), and is continued in U.C.C. § 3-305(1)(a). *See* Warren, *Cutting Off Claims of Ownership Under the Uniform Commercial Code*, 30 U. Chi. L. Rev. 469, 478-79 (1963).

[41]Comment, 26 St. John's L. Rev. 135 (1951). Other illustrations of equitable claims of ownership are found in U.C.C. § 3-306, Comment 5:

Defenses to payment, such as breach of warranty and failure of consideration, do not challenge the holder's rightful ownership of the instrument. These defenses are more like counterclaims that challenge the holder's right to collect the full amount of the instrument.[42] This area is complicated by a further division of claims and defenses into first-party claims and defenses, and third-party claims and defenses.

2. First-Party Claims and Defenses, and Third-Party Claims and Defenses.—If the person objecting to payment is raising a claim or defense of his own, a first-party claim or defense is involved. If the claim of title, or defense, belongs to a third party, a third-party claim or defense is involved.

It is sometimes possible to view an objection to payment as fitting within more than one category. However, the simpler cases fit solely within one classification. For example, if a drawer uses a check to pay for goods that do not meet the quality standard of an express or implied warranty, the objection to payment would be a first-party defense of breach of warranty. However, if a drawer delivers a check drawn to the order of a payee, and the check is stolen from the payee, forged by the thief, and presented for payment by a transferee from the thief, the objection to payment is both a first-party defense and a third-party legal claim of title. The drawer has a first-party defense to payment, he is obliged to pay the instrument to any holder, and the person presenting the check is not such a holder.[43] At the same time, the facts also establish that title to the instrument is still in the payee, and the drawee can resist payment by attempting to assert his third-party's (the payee's) claim of ownership.

> The provision includes all claims for rescission of a negotiation, whether based in incapacity, fraud, duress, mistake, illegality, breach of trust or duty or any other reason. It includes claims based on conditional delivery or delivery for a special purpose. It includes claims of legal title, lien, constructive trust or other equity against the instrument or its proceeds.

[42]Defenses are divided into two sub-classes: Those that are available against all holders; and those that are available only against mere holders, but not against holders in due course. The Negotiable Instruments Law categorized the former sub-class as "real" defenses and the latter as "personal" defenses. 2 R. ANDERSON, *supra* note 8, § 3-305.3

The Uniform Commercial Code abandons the "real" and "personal" labels although both are still commonly used. The only defenses available under the Code against holders in due course are those listed in U.C.C. § 3-305(2); plus forgery, which is made a "real" defense by U.C.C. § 3-404; and material alteration, which is made a "real" defense by U.C.C. § 3-407.

[43]A holder is a person in possession of a negotiable instrument which, in the case of order paper, must have been indorsed by the original payee. U.C.C. §§ 1-201(20), 3-202 & 3-204.

3. The Status of the Holder.—The holder of the instrument may be either a holder in due course or a mere holder of the instrument. If the holder is a holder in due course, he can enforce the instrument free from all legal and equitable ownership claims of any person to the instrument and free from many first and all third-party defenses. The only defenses a holder in due course is subject to are those known as "real defenses," and then only those real defenses that are first-party defenses.[44]

A mere holder's ability to collect on the instrument is governed by section 3-306 of the Code. This section provides:

> Unless he has the rights of a holder in due course any person takes the instrument subject to
> (a) all valid claims to it on the part of any person; and
> (b) all defenses of any party which would be available in an action on a simple contract; and
> (c) the defenses of want or failure of consideration, non-performance of any condition precedent, non-delivery, or delivery for a special purpose (Section 3-408); and
> (d) the defense that he or a person through whom he holds the instrument acquired it by theft, or that payment or satisfaction to such holder would be inconsistent with the terms of a restrictive indorsement. The claim of any third person to the instrument is not otherwise available as a defense to any party liable thereon unless the third person himself defends the action for such party.

This section is not an easy one to understand. This author believes it establishes the following rules in regard to the bank's ability to raise the *jus tertii* of its customer.

1. Subsection (a).—The bank may assert any claim to title it may have, or a third person could recover the instrument from the holder prior to payment of the instrument;[45] but this subsection does not authorize the bank to raise a third person's legal or equitable claim of ownership as a basis for objecting to its obligation to pay the instrument to the holder. Thus, subsection (a) only allows the bank to raise first-party claims.

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[44]U.C.C. § 3-305(2) provides what is almost an exclusive list of the "real defenses" available against a holder in due course. The five subparts to subsection (2) rather clearly limit the defenses to first-party rather than third-party defenses. Note, *Personal Money Orders and Teller's Checks: Mavericks Under the UCC*, 67 COLUM. L. REV. 524, 547 (1967).

[45]Warren, *supra* note 40, at 479-80.

2. Subsection (b).—This subsection allows the bank to raise defenses of its own to payment of the instrument but does not authorize the bank to utilize a third person's defenses as a basis for objecting to its obligation to pay the instrument.

3. Subsection (c).—This subsection is designed to insure that certain defenses will always be available as first-party defenses, even if they would not "be available in an action on a simple contract" under subsection (b).[46] However, this subsection does not authorize the bank to utilize a third person's defenses as a basis for its objection to payment of the instrument. Thus, subsections (b) and (c) allow the bank to raise a great number of first-party defenses but do not authorize the bank to raise third-party defenses of any kind.

4. Subsection (d).—This subsection permits the bank to raise two third-party "defenses" to payment: Theft, or violation of a restrictive indorsement. These two objections are really third-party legal claims of title to the instrument and not mere defenses.[47] This subsection then goes on to provide that other third-party claims cannot be raised "unless the third person himself defends the action for such party."[48] Third-party defenses, such as breach of warranty, are not even mentioned.

The U.C.C.'s treatment of third-party equitable claims of ownership and defenses can best be understood from a historical perspective. Legal claims of ownership have traditionally been recognized as valid objections to payment of an instrument, and the law of negotiable instruments has always allowed such claims of ownership to be raised by either the true owner of the instrument or a third party who is liable on the instrument.[49] Hence, a drawer or acceptor could always successfully object to payment because the holder was not the true owner of the instrument, regardless of whether the drawer or acceptor was the true owner, or some third party was the true owner.

The common law of negotiable instruments seemed to prohibit an acceptor or drawer from asserting third-party equitable claims of ownership or third-party defenses as a basis for objecting to his own

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[46]J. White & R. Summers, Uniform Commercial Code, § 14-11 (1972).

[47]These "super-claims," which the bank can raise as objections to payment even without the intervention of the bank customer, have been deliberately singled out for such special treatment. The theft "claim" is so treated because of "the policy which refuses to aid a proved thief to recover." U.C.C. § 3-306, Comment 5. The restrictive indorsement "claim" has been made available to the bank to mesh with the Code's special treatment of restrictive indorsements in other contexts. *See* U.C.C. §§ 3-205, 3-206 & 3-603.

[48]U.C.C. § 3-306(d).

[49]W. Britton, Bills and Notes § 158 (2d ed. 1961); Britton, *supra* note 39, at 23; Comment, 26 St. John's L. Rev. 135, 139 (1951).

liability on the instrument.[50] However, some courts operating under the Negotiable Instruments Law began to permit the assertion of third-party equitable claims of ownership, and even third-party defenses.[51] The draftsmen of the U.C.C. sought to return to the more restrictive common law view, which prohibited the utilization of third-party equitable claims or defenses, and section 3-306(d) is the result of this desire. While this section is not as clearly drafted as it could be, the intent was to allow the accepting or certifying bank to raise third-party legal claims of ownership in the context under discussion and to prohibit the bank from raising third-party equitable claims of ownership or third-party defenses, even where the holder of the instrument was not a holder in due course.

The bank customer's equitable claims of ownership can be raised only if the bank customer personally defends the holder's action against the bank.[52] However, third-party defenses are completely unavailable, even if the bank wishes to aid its unhappy customer and refuses to pay the instrument. When the holder sues on the instrument, the bank cannot raise its customer's defenses, and the customer appears to have no right to intervene in the lawsuit to raise his defenses on his own. The holder, even though not a holder in due course, collects the full amount of the instrument.[53]

Thus, even if the bank cooperates with its customer by dishonoring its contractual obligations on the instrument, the bank's ability to utilize the *jus tertii* of its customer is limited to legal claims of ownership. The bank may raise its customer's *equitable* claims of ownership only if the customer intervenes in the lawsuit or is otherwise involved as a party. But the bank may not raise its customer's *mere defenses* to payment, even if the customer seeks to be involved in the litigation. Since defenses to payment are the most common form of objection to payment of an instrument, the bank customer is in large part unable to prevent payment on a bank instrument even when the bank is cooperating.

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[50]Britton, *supra* note 39, at 23; Comment, 26 St. John's L. Rev. 135, 139 (1951).

[51]Britton, *supra* note 39, at 24; W. Britton, Bills and Notes § 159 (2d ed. 1961); Note, *Blocking Payment on Certified, Cashier's and Bank Checks*, 73 Mich. L. Rev. 424, 431 (1973).

[52]*Fulton Nat'l Bank v. Delco Corp.*, 128 Ga. App. 16, 195 S.E.2d 455, 457 (1973).

[53]U.C.C. § 3-306, Comment 5. This comment provides, in part:

> Nothing in this section is intended to prevent the *claimant* from intervening in the holder's action against the obligor or defending the action for the latter, and asserting his *claim* in the course of such intervention or defense. Nothing here stated is intended to prevent any interpleader, deposit in court or other available procedure under which the defendant may bring the *claimant* into court or be discharged without himself litigating the claim as a defense. (Emphasis added.)

This paragraph refers only to claims and claimants, and is further evidence of the Code draftsmen's intent to prevent the utilization of defenses in all situations.

E. Bank Responsibility upon Notice of Adverse Claim

A troublesome problem arises for the bank's customer when the bank is reluctant or unwilling to breach its own contractual obligation on the instrument. The reluctant bank might be pacified by an offer of indemnification, but the bank customer's only method of preventing the unwilling bank from honoring its contractual obligation is by the assertion of an "adverse claim" to the instrument.

Under the common law and the Negotiable Instruments Law, the bank customer could assert an "adverse claim" to the instrument by merely giving notice to the bank of the existence of this outstanding claim.[54] The word "claim" was, however, limited to claims of title of either a legal or equitable nature, and mere defenses did not give rise to a right to assert an adverse claim.[55] A bank which proceeded to pay an instrument after receiving notice of an adverse title claim would remain liable to the claimant, even though payment had been made to the holder.[56] Thus, banks were faced with a risk of double liability if they paid an instrument after receiving notice of an adverse claim. Occasionally, a bank might refuse to pay an instrument after receiving notice of an adverse claim then be held liable to the holder in one action and liable again to the adverse claimant in another action.[57] Double liability was possible even if the bank heeded the notice of adverse claim.

The U.C.C. continues to allow the bank customer to raise adverse claims but has restricted the effect of the bank's failure to heed the notice of this adverse claim.[58] Section 3-603 provides that payment to a holder discharges the liability of any person on an instrument even if made with knowledge of an adverse claim. In only two situations must the bank assert its customer's objection, or else remain liable on the instrument. A bank that in bad faith pays a stolen instrument or pays a restrictively indorsed instrument in a

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This total inability to utilize a third-party defense, even if the third party is a party to the law suit, is consistent with the traditional common law rule on this question. Note, *Personal Money Orders and Teller's Checks: Mavericks Under the U.C.C.*, 67 COLUM. L. REV. 524, 546 (1967); Uniform Commercial Code Commentary, 4 B.C. INDUS. & COM. L. REV.. 459, 463 (1963).

[54]H. BAILEY *supra* note 8, §§ 10.9 10.10; W. BRITTON, *supra* note 48, § 159; Note, *Automatic Discharge of Negotiable Instruments in the Proposed Commercial Code*, 44 ILL. L. REV. 88 (1949).

[55]Note, *Blocking Payment on a Certified, Cashier's or Bank Check*, 73 MICH. L. REV. 424, 436 (1973).

[56]Comment, *Adverse Claims Under the Uniform Commercial Code: A Survey And Proposals*, 65 YALE L.J. 807, 810-11 (1956).

[57]*Id.* at 811.

[58]H. BAILEY, *supra* note 8, at §§ 10.9, 10.10; *supra* note 39, at 25-26; Comment,*Automatic Discharge of Negotiable Instruments in the Proposed Commercial Code*, 44 ILL. L. REV. 88, 94-95 (1949).

manner not consistent with the restrictive indorsement is not discharged by such payment, even if the third party does not supply indemnity, does not obtain an injunction, or does not participate voluntarily in the defense of any lawsuit that the holder may commence.[59] However, the bank may, in all other cases, proceed to pay the instrument without fear of any liability to its customer.[60]

The bank customer may prevent the bank from receiving the discharge when he has an adverse title claim based on facts other than theft or violation of a restrictive indorsement if he either obtains an injunction or posts indemnity "deemed adequate"[61] by the bank. However, the injunction possibility is of limited practical value to the bank customer. To be effective under section 3-603, the injunction must be obtained in an action to which both the bank and the holder are parties.[62] Aside from the jurisdictional problems raised by this requirement, the injuction must be obtained before the uncooperative bank has paid the instrument, and as a practical matter, this may be an impossible task.[63]

The indemnification possibility appears to be of mere practical significance to the adverse claimant, although the situation is replete with uncertainties regarding the apparently uncontrolled discretion of the bank to determine the adequacy of the offered indemnification.[64] In any event, the requirement that the bank customer's objection to payment be based on an adverse title claim

[59]U.C.C. § 3-603(1)(a) & (b). These sections deal only with the bank's discharge on the instrument. The bank might remain liable to the true owner of a stolen instrument. The bank also could be held liable on another theory, such as conversion if it paid a restrictively indorsed instrument in a manner not consistent with the restrictive indorsement. *See* U.C.C. § 3-419.

[60]This represents a significant change from the rule under the Negotiable Instruments Law. Under § 119 of that statute, the paying bank was discharged only if it paid "in due course," which meant without notice of a defect in the holder's title. Under the U.C.C., the discharge is absolute, even if made with notice of such a defect, except in the two situations specifically treated differently by U.C.C. § 3-603 itself. Chenowith v. Bank of Dardanelle, 243 Ark. 310, 419 S.W.2d 792 (1967); Morrison & Sneed, *supra* note 5, at 272-73; Comment, *Automatic Discharge of Negotiable Instruments in the Proposed Commercial Code,* 44 U. ILL. L. REV. 88, 88-89 (1949); Comment, *Adverse Claims Under the Uniform Commercial Code: A Survey and Proposals,* 65 YALE L.J. 807, 810-12 (1956).

[61]U.C.C. § 3-603(1).

[62]The language of U.C.C. § 3-603 clearly requires this: The adverse claimant must enjoin payment" by order of a court of competent jurisdiction in an action in which the adverse claimant and the holder are parties."

[63]The only reported case involving the use of an injunction in an adverse claim situation is Jefferies & Co. v. Arkus-Duntov, 357 F. Supp. 1206 (S.D.N.Y. 1973).

[64]Comment, *Adverse Claims Under the Uniform Commercial Code: A Survey And Proposals,* 65 YALE L.J. 807, 813-14 (1956). The only reported decision involving an attempted indemnification in an adverse claim situation is *National Newark & Essex Bank v. Giordano,* 111 N.J. Super. 347, 268 A.2d 327 (1970).

prevents the bank customer from utilizing this method of preventing payment in the most common kinds of cases. Most dissatisfied bank customers only have a defense to payment, and defenses may not be raised under the doctrine of adverse claim.

This analysis suggests that where a bank is primarily liable on an instrument, it is almost impossible for a bank customer to effectively object to payment even if he can convince the bank to dishonor its obligation, or, in the case of an uncooperative bank, obtain an appropriate injunction or offer indemnity quickly enough to prevent the bank from complying with its contractual obligations under the U.C.C. For even if the initial payment can be prevented, the bank customer is unlikely to be successful in seeing his objections to payment utilized in any subsequent litigation brought by the holder. At the very best, only claims can be raised, and mere defenses to payment are unavailable as a basis for objecting to payment.

III. A Question of Policy

There seems to be little doubt that the draftsmen of the U.C.C. deliberately sought to create the body of law described above.[65] The draftsmen wanted to accomplish at least two things. First, there was a perceived need for forms of negotiable instruments that would function as an almost complete substitute for cash. In order to serve as a satisfactory substitute for cash, these negotiable instruments had to satisfy the two principal concerns of any person who accepted them as a form of payment. Such a person would have to be satisfied that the credit of a substantial business entity stood behind the instrument and that payment by means of such an instrument would produce much of the finality that would be produced by payment in cash. Both of these expectations are satisfied when a bank check is used as the form of payment. In the absence of bank insolvency, or the relatively minor possibilities of successful *jus tertii* or adverse claim assertions, bank checks provide both a certainty of credit and finality of payment. This part of the policy decision is thus rooted in the business and commercial needs of a modern society.[66]

The second principal goal was to eliminate the potential for double liability.[67] This goal has been met through the careful draftsman-

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[65]Note, *Blocking Payment on a Certified, Cashier's or Bank Check*, 73 MICH. L. REV. 424, 431 (1974); Comment, *Adverse Claims Under The Uniform Commercial Code: A Survey And Proposals*, 65 YALE L.J. 807, 812-13 (1956).

[66]National Newark & Essex Bank v. Giordano, 111 N.J. Super. 347, 351-52, 268 A.2d 327, 329 (1970); Strahorn, *The Policy Or Function Of The Law Of Bills And Notes*, 87 U. PA. L. REV. 662 (1939).

[67]Comment, *Adverse Claims Under The Uniform Commercial Code: A Survey And Proposals*, 65 YALE L.J. 807, 812 (1956).

ship of section 3-603. In addition, the draftsmen wanted to insulate the bank from possible entanglements in conflicting claims to a right of payment represented by the instrument or in litigation arising out of such conflicting claims, at least in situations where the bank was not willing to assume these risks. Hence, when the bank is not willing to cooperate with its customer and dishonor its obligation, the customer is severely limited in his ability to prevent the bank from paying the instrument and obtaining a total discharge of liability within the rules of section 3-603 of the Code.

Even where the bank is willing to accommodate its customer and dishonor its obligation, section 3-306 of the Code limits those classes of objections that can be used successfully. This gives the bank an excuse for not honoring a customer's request that payment be denied[68] and also serves to protect the holder's expectation that payment by means of a bank check is final.

It would appear that the existing policy choice, which fosters the essential equivalence of bank checks to cash, has the effect of promoting the interests of an alleged wrongdoing holder of the instrument at the expense of the bank customer[69] who is frustrated in his attempt to prevent this person from collecting the full amount of the instrument although the holder may not have fulfilled his part of the transaction. This past decade has seen an increasing concern for the protection of the interests of consumers, and in some situations, consumers are the unhappy users of bank checks.

It is not surprising that there have been both judicial and non-judicial suggestions that these rules be changed to preserve equitable title claims and defenses when a non-holder in due course is in possession of a bank check. One suggestion is that the rules of sections 3-603 and 3-306 be changed by amending the Code.[70] Another is that the term "claims" be read very broadly under these two sections as they presently exist so as to encompass defenses such as breach of warranty.[71] This would allow the bank customer to successfully raise these defenses.

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[68]Section 3-306(d) prohibits the utilization of equitable title claims unless the claimant is directly involved. Comment 5 somewhat paternalistically states:

> The contract of the obligor is to pay the holder of the instrument, and the claims of other persons against the holder are generally not his concern. He is not required to set up such a claim as a defense, since he usually will have no satisfactory evidence of his own on the issue; and the provision that he may not do so is intended as much for his protection as for that of the holder.

[69]Comment, *Automatic Discharge of Negotiable Instruments in the Proposed Commercial Code*, 44 ILL. L. REV. 88, 95 (1949).

[70]Note, *Blocking Payment on a Certified, Cashier's or Bank Check*, 73 MICH. L. REV. 424, 441 (1974).

[71]Comment, 67 NW. U.L. REV. 915, 926 (1973). It has also been suggested that the entire concept of negotiability needs to the rethought and that the partial or total

The extent of the judicial interest in protecting a consumer who has used a bank check for payment can be seen in a recent decision, *Dziurak v. Chase Manhattan Bank.*[72] This case, though overruled on appeal, demonstrates the lower courts concern with the plight of the consumer. *Dziurak* involved an individual who was defrauded in a transaction involving the purchase of a part interest in a small business. The court referred to the bank customer, who had used a cashier's check to purchase this interest, as "unsophisticated."[73] The court, while fully recognizing that a traditional analysis would prevent a bank customer from stopping payment on a cashier's check, refused to follow that analysis.[74] Instead, the court ruled that the bank had acted improperly in refusing to honor its customer's request that payment be stopped or that the instrument by dishonored.[75] This decision is clearly outside the mainstream of judicial authority on this question. Nevertheless, it does show the concern for the protection of consumers who may have a defense to payment where the objection does not rise to the level of a claim that can be successfully asserted, or where the consumer has an equitable title claim, as in *Dziurak*, but does not know of or attempt to use the injunction or indemnity options of section 3-603.

The need for a form of negotiable instrument that is an adequate substitute for cash and the desire to protect the hapless consumer who has chosen to use such an instrument seems to have created an irreconcilable conflict. The existing rules function to prevent the successful assertion of consumer defenses to payment that arise before the instrument has been collected, and the complicated rules on *jus tertii* and adverse claim will frequently cause even equitable title claims to be lost.

A direct amendment to the U.C.C. or the adoption of consumer protection legislation could change the current situation and establish the ability of the consumer users of these instruments to simply and successfully raise defenses and equitable title claims. If such legislation were to be adopted, the bank that is being asked to dishonor its contractual liability should be protected by an adequate indemnification provision when the dishonor is for the customer's benefit. This would not only protect the bank from the financial

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elimination of the concept would be to the benefit of society. Rosenthal, *Negotiability—Who Needs It?* 71 COLUM. L. REV. 375 (1971).

Not all commentators find the existing rules undesirable. *See, e.g., Uniform Commercial Code Commentary,* 8 B.C. INDUS. & COM. L. REV. 260, 264 (1967).

[72] 88 Misc. 2d 641, 388 N.Y.S.2d 496 (N.Y. Sup. Ct. 1976), *rev'd* 396 N.Y.S.2d 414 (App. Div. 1977).

[73] *Id.* at 647, 388 N.Y.S.2d at 501.

[74] *Id.* at 643, 388 N.Y.S.2d at 498-99.

[75] *Id.* at 650, 388 N.Y.S.2d at 502-03.

burden of defending the holder's claim for payment but would also help insure that the customer would actively defend the action on behalf of the bank.

There may be a question about the seriousness of the need for such protective legislation. The Uniform Consumer Credit Code[76] and the recently adopted Federal Trade Commission restrictions[77] on the holder in due course concept do not prevent the use of personal checks on which a holder could become a holder in due course with a right to enforce the instrument directly against the consumer free of all title claims and personal defenses.[78] Certainly a holder in due course of a bank instrument would also, at least within existing statutory frameworks, be able to collect on a bank check. It is only when the holder is not a holder in due course that the U.C.C. rules on *jus tertii* and adverse claim provide greater protection from defenses for the holder than either of these consumer protection schemes provide for the holder of a personal check. Where an equitable title claim is involved, the existing scheme does provide equivalent treatment once the cumbersome conditions precedent of intervention under section 3-306(d) or injunction or indemnity under section 3-603 have been satisifed. Thus, proposed legislation would not have to do anything more than insure that a consumer's defenses and equitable claims would be easily available against a non-holder in due course of a bank instrument upon the offer of a defined type of indemnity in order to virtually equalize the treatment of personal and bank checks in this regard.

IV. Conclusion

The drawer of a personal check has an absolute right to stop payment on the instrument, a right which can be of great practical significance to the drawer, regardless of whether the instrument is held by a mere holder or a holder in due course. A person who uses a bank check instead of a personal check has given up the power to stop payment, and his ability to prevent payment of the instrument through more indirect means involving *jus tertii* or adverse claim assertions is very limited.

In those cases where a bank check has been used as the form of payment in a business transaction, the existing rules seem to create

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[76]U.C.C.C. § 2.403 (1970) prohibits the seller from taking a negotiable instrument other than a check in a consumer transaction.

[77]Preservation of Consumers' Claims and Defenses, 16 CFR 433 (1977). The FTC regulations require certain language to be included in consumer notes and consumer credit contracts that subject the holder to most consumer defenses.

[78]The U.C.C.C. specifically allows the use of checks. See U.C.C.C. § 3.307 (1974). The FTC rule is aimed only at credit transactions.

an acceptable balance between the conflicting policy considerations. Legal claims of ownership, at least those involving theft and violation of restrictive indorsements, can be raised by the bank and must be raised if the bank is to obtain a discharge of its liability on the instrument. Equitable claims of ownership can be utilized by the cooperative bank under section 3.306(d) of the U.C.C. if the customer assists in the defense of the holder's action on the instrument, or through the use of an injunction or indemnification offer under section 3.603 if the bank is not willing to cooperate with its customer.

Defenses, while they are the most common basis for objection, rarely involve a sufficient degree of wrongdoing to justify interfering with the need for forms of negotiable instruments that are essentially equivalent to cash.

In those cases where a bank check has been used as the form of payment in a consumer transaction, the greater level of concern for the plight of the consumer may well call for a different set of rules. There appears to be no excuse for not preserving a consumer's defenses when the holder of the bank instrument is not a holder in due course, or for not simplifying the procedures of preserving equitable title claims.

Comment

The Future of the Federal District Courts

*The Honorable William E. Steckler**

The title of my lecture promises more than it can produce. Predicting the future of the federal district courts is, at best, a highly speculative venture—a task calling for oracular powers which I do not possess.

It has been said that "[t]he future is like a corridor into which we can see only by the light from behind."[1] Even with twenty-eight years to my credit on the federal bench, it would be foolhardy on my part to have you believe that by my acceptance of the challenge of my topic for discussion that I could predict the future of the federal district courts. Therefore, I shall merely share some of my thoughts with you as to what I perceive to be in store for the federal district courts and perhaps a few of my notions for improvement in the district court system. Before embarking on that subject, however, I would like to briefly examine some important historical developments in our federal judicial system.[2]

I. The Development of the Federal Judiciary

The present institutions and powers of the federal judicial system are firmly rooted in article III of the United States Constitution and the Judiciary Act of 1789.[3] However, the Constitutional Convention was initially unresolved as to the structure of the federal court system. Those supporting the establishment of the Supreme Court and inferior tribunals were opposed by those who raised the issues of additional expense and the adequacy of direct appeal from the state courts to the Supreme Court. Eventually the Convention reached a compromise, now embodied in article III, to the effect that the Constitution should empower the national legislature to create the lower federal courts, rather than expressly create those courts in article III. Thus, under the present system, Congress may establish or disestablish the inferior federal tribunals,[4] including, of course, the federal district courts.

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[1]Goldman, Hooper & Mahaffey, *Caseload Forecasting Models for Federal District Courts*, 5 J. Legal Stud. 201, 233 (1976).

[2]For an excellent and more detailed discussion of the history of the federal judiciary, *see generally* C. Wright, Handbook of the Law of Federal Courts § 1 (3d ed. 1976).

[3]Act of Sept. 24, 1789, 1 Stat. 73 (now generally codified as amended at 28 U.C.C. §§ 1-2906 (1970 & Supp. V 1975)).

[4]U.S. Const. art. III, § 1.

In the course of the two centuries following the Constitutional Convention, Congress has fashioned a bi-level lower court system of varying jurisdictions and proportions. The Judiciary Act of 1789[5] instituted a six-member Supreme Court, three circuit courts, and at least one district court per state. Circuit courts had original jurisdiction in diversity cases, most criminal cases, and larger cases to which the United States was a party. They also had appellate jurisdiction over civil district court cases involving up to $50 in controversy, and admiralty cases in which the amount in controversy exceeded $300.

Under the 1789 Act, the district courts were entirely courts of original jurisdiction authorized to hear admiralty cases, minor criminal cases, and some other rather limited classes of cases. The district courts had no jurisdiction for review of administrative agencies' decisions, because there was really no occasion for such reviews. The Act granted the Supreme Court appellate jurisdiction over the circuit courts in civil cases involving over $2000 in controversy and over the state courts in cases raising federal questions, in addition to the original jurisdiction provided by the Constitution. The Court did not possess jurisdiction to review federal criminal cases.

It is interesting to note that

> Congress proceeded immediately to give the circuit courts jurisdiction in diversity cases, but that no jurisdiction was conferred on the lower courts in cases arising under the Constitution or laws of the United States. Except for a grant in 1801 that lasted little more than a year, not until 1875 was there a general grant of federal question jurisdiction; such cases could only be brought in the state courts.[6]

In 1875, Congress finally granted the district courts original jurisdiction nearly as broad as the constitutional grant over cases arising under the Constitution, laws, and treaties of the United States.[7] Because the circuit courts received no judges of their own under the 1789 Act, district court judges and Supreme Court justices manned the circuit court bench until 1869, when Congress appointed the first circuit court judges, concurrently relieving the Supreme Court justices from most circuit duties and releasing the district court judges from all such duties.[8] In the Evarts Act of 1891,[9] Congress

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[5]Act of Sept. 24, 1789, 1 Stat. 73.

[6]C. Wright, *supra* note 2, at 4.

[7]Act of March 3, 1875, § 1, 18 Stat. 470.

[8]Act of Apr. 10, 1869, 16 Stat. 44.

[9]Act of March 3, 1891, 26 Stat. 826.

created a circuit court of appeals in each circuit and eliminated the appellate jurisdiction of the circuit courts. This enactment resulted in two federal courts of exclusive original jurisdiction, until 1911 when Congress abolished the circuit courts and transferred their jurisdiction to the district courts.[10]

The Evarts Act also introduced the principle of discretionary appellate review by means of the writ of certiorari, a principle expanded upon in the "Judges' Bill" of 1925.[11] This latter piece of legislation, drafted by a committee of Supreme Court justices with the aim of reducing the Court's caseload, enabled the Supreme Court to use full discretion with regard to the review of federal and state appellate cases, except in those cases involving exceptional urgency or a clash within the Supremacy Clause.[12] Aside from the recodification of the Judicial Code in 1948[13] and subsequent amendments, the provisions of the Judges' Bill essentially gave rise to the federal judicial system as we know it today. Against the structural background, we should shift our emphasis to reasons why the system has changed and why there is continued pressure for reform.

II. Pressure for Reform

In 1928, Felix Frankfurter and James M. Landis stated that "the range and intensity of governing political, social and economic forces are accurately reflected in the volume and variety of federal litigation."[14] Others have offered variants to that theme, but each "can be summed into an elementary proposition: the business of the courts—whether trial or appellate—flows from processes in our social, economic, and political life."[15]

Professor Phillip M. Hauser, Director of the Population Research Center at the University of Chicago, has demonstrated in bold relief that "demographically, we [Americans] are very different from those who created our basic legal institutions."[16] According to his data,

> in the two centuries between 1790 and the year 2000, we shall have grown from 4 to 275 million persons. While our

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[10]Act of March 3, 1911, §§ 24, 289, 36 Stat. 1087.

[11]Act of Feb. 13, 1925, 43 Stat. 936.

[12]*Id.* § 1.

[13]Act of June 25, 1948, 62 Stat. 869 (now generally codified as amended at 28 U.S.C. §§ 1-2906 (1970 & Supp. V 1975)).

[14]F. Frankfurter & J. Landis, The Business of the Supreme Court: A Study of the Federal Judicial System 56 (1928).

[15]Goldman, Hooper & Mahaffey, *supra* note 1, at 202.

[16]Schwartz, *Introduction*, in Law and the American Future 2 (Schwartz ed. 1976) (citing Hauser, *Demographic Changes in the Legal System*, in Law and the American Future (Schwartz ed. 1976)). This matter is used with permission of the publisher, Prentice-Hall, Inc., Englewood Cliffs, New Jersey.

> annual birth rate has declined from 55 persons per 1,000 to 14, our life expectancy has increased from less than forty years at birth to over seventy. . . . We have moved from rural areas in which 95 percent lived in 1790, to the urban environment, where 75 percent lived in 1970.[17]

Today we are also very different in our racial distribution. Pointing to the massive migration of blacks from southern rural areas to the cities, Professor Hauser has noted that in 1910, 89% of blacks lived in the South; by 1970, only 53% lived there. In 1910, 73% of blacks lived in rural areas throughout the country; by 1970, 81% lived in urban areas.[18] During that same time, growth of the black population exceeded that of the white population. For example, between 1960 and 1970, the black population increased by 23%, as contrasted to a 12.3% increase in the white population.[19] And, as Professor Murray L. Schwartz has stated, drawing on Professor Hauser's data, "We are an aging, urban, increasingly nonwhite population, with smaller families and fewer children—a far cry from the population which ratified the Constitution of the United States and the Bill of Rights."[20]

Our leadership in advanced technology has led us to the world's highest standard of living, but at great cost in the expenditure of our finite resources. We are paying heavily, and in the future we shall have paid even more heavily, in ecological and environmental changes brought on by these technological advancements.

Our present mass society, in contrast to the folk society of yesteryear, is characterized by considerable division of labor and specialization in function. The social and economic order have become much more interdependent and therefore more vulnerable to disruption. New risks to the individual have emerged, including the risk of disrupted income flow through unemployment and the risk of consumer exploitation, while increased chronic illness and physical impairment have accompanied the extension of life expectancy.

In short, as Professor Hauser has stated, the social morphological revolution *has greatly diminished the ability of the individual for self-determination* in the sense that it has greatly increased his dependence on the smooth functioning of the highly interdependent economy and society. As a result of this dependence, ever increasing numbers of aggrieved persons are seeking access to the courts to resolve their disputes, resulting in a tremendous in-

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[17]*Id.* at 2-3.

[18]Hauser, *supra* note 16, at 21.

[19]*Id.* at 22.

[20]Schwartz, *supra* note 16, at 3.

crease in lawyer population, a principal indicator of pressure on the courts.[21] Witness, for example, the fact that the number of law students in the nation's law schools has increased from 53,000 in 1950 to over 125,000 in 1976. Predictably the number will be 150,000 shortly after the turn of the century.[22]

As these populations increase, it is apparent that there will be more cases brought before the federal courts and, concomitantly, a need for more federal judgeships. At my request, officials of the Administrative Office of the United States Courts[23] have made an unofficial projection of the number of judgeships and caseloads in the federal district courts in the year 2000. Their projection indicates that if the growth in caseload continues, following the pattern of the past thirty years, and if Congress responds with more judgeships, the number of district judges in the year 2000 will have grown from the present 401 to 880, and these judges will have an annual combined civil and criminal caseload of 288,000, or 327 cases per judgeship. In 1977, the number of filings was 163,492, or 411 per judgeship.[24]

III. Reshaping the Federal Judiciary

A. Powers of Magistrates

One of the areas where the district courts are experiencing significant changes is in the area of its supporting personnel, particularly magistrates.[25] In 1968, Congress passed the Federal Magistrates Act. It was designed to replace the United States Commissioner system and to provide an upgraded system of judicial officers with greater responsibilities and greater qualifications. The Act established three types of jurisdiction for United States magistrates. First, it gave magistrates all the duties which were formerly performed by the United States Commissioners.[26] These duties generally related to the initial proceedings in criminal cases, such as the issuance of arrest and search warrants, conduct of bail hearings, and preliminary examinations. Second, the Act gave magistrates expanded trial jurisdiction. Under 18 U.S.C. § 3401,

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[21]Hauser, *supra* note 16, at 24.

[22]Conversation with William F. Harvey, Dean of Indiana University School of Law—Indianapolis, in Indianapolis (April 10, 1978).

[23]Among the duties of the Director of the Administrative Office of the United States Courts is the responsibility for preparing statistical information relating to the state of business of the courts, court dockets and the business which has come before the various United States magistrates. 28 U.S.C. § 604(a), (b), (d) (1970 & Supp. V 1975).

[24]Letter from Joseph F. Spaniol, Jr., Deputy Director of the Administrative Office of the United States Courts (March 7, 1978).

[25]Pub. L. No. 90-578, 82 Stat. 1108 (1968) (codified in scattered sections of 18, 28 U.S.C.).

[26]28 U.S.C. § 636(a)(1) (1970).

magistrates have jurisdiction to try and sentence defendants in "minor offense" cases.[27] A "minor offense" is defined as any federal misdemeanor for which the maximum penalty does not exceed one year's imprisonment or a $1,000 fine, or both.[28] Third, the Act authorized the district courts to establish rules under which a full-time magistrate or a specially designated part-time magistrate may be assigned such "additional duties" as are not inconsistent with the Constitution and laws of the United States. Under the 1968 Act, the additional duties authorized by rule could include, but were not restricted to (1) service as a special master in appropriate civil actions, pursuant to applicable provisions of Title 28 and the Federal Rules of Civil Procedure; (2) assistance to a district court in the conduct of pretrial or discovery proceedings in civil or criminal actions; and (3) preliminary review of applications for post-trial relief made by individuals convicted of criminal offenses and submission of a report and recommendation to facilitate the decision of the district judge having jurisdiction over the case as to whether there should be a hearing.[29]

By July 1, 1971, the magistrates system had been established in every federal district. From the very beginning, jurisdictional questions developed because the Act was vague and broad. A diversity of opinion developed in the decisional case law among the appellate courts as to the type of duties which could be appropriately delegated by judges to the magistrates. Several court decisions invalidated references of duties to magistrates.[30] A number of courts from the outset made very extensive use of magistrates to expedite the caseloads of the courts. Nevertheless, the uncertainty in the law led several courts to hold back in assignment of duties to magistrates.

Finally, in June 1974, the Supreme Court, in *Wingo v. Wedding*,[31] held that a magistrate could not conduct an evidentiary hearing in a habeas corpus case, based on the language of the Habeas Corpus Act and the Magistrates Act as then written.[32]

As stated by Peter G. McCabe, Chief of the Magistrates Division, Administrative Officer of the United States Courts, a propitious group of factors converged in 1974 and 1975 to provide im-

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[27]18 U.S.C. § 3401(a) (1976).

[28]*Id.* § 3401(f).

[29]28 U.S.C. § 636(b) (1970) (amended 1976).

[30]Wedding v. Wingo, 483 F.2d 1131 (6th Cir. 1973), *aff'd*, 418 U.S. 461 (1974); Ingram v. Richardson, 471 F.2d 1268 (6th Cir. 1972); T.P.O., Inc. v. McMillen, 460 F.2d 348 (7th Cir. 1972).

[31]418 U.S. 461 (1974).

[32]*Id.* at 469-72 (citing Habeas Corpus Act, 28 U.S.C. § 2243 (1970), and Federal Magistrates Act, 28 U.S.C. §§ 631-639 (1970)).

petus to the Judicial Conference of the United States to seek substantive changes in the jurisdictional provisions of the Act.[33] First of all, Chief Justice Burger dissented vigorously in *Wingo* and expressly invited the Congress to enact new legislation to clarify the law.[34] Second, the caseload of the district courts continued to grow at a rapid rate. In addition to the normal increase in caseload, Congress had passed a series of laws which brought new causes of action into the federal trial courts.[35]

The Judicial Conference of the United States concluded that although additional judges were needed, the courts could not continue to cope with the problem of growing caseload by merely periodically increasing the number of judges, together with their supporting staffs of law clerks, secretaries, criers, deputy clerks, and court reporters, and concurrently allocating tremendous amounts of additional space to the federal court system. Moreover, a magistrate position costs substantially less than half the cost of a federal judgeship. Thus, in light of the limited resources that will always be available, the Judicial Conference adopted, and continues to adopt, the view that the courts must make full use of the magistrates.[36]
magistrates.[38]

Additionally, in 1974, a privately funded delegation of federal trial judges went to England to study the use of masters in the British system. Upon their return, they submitted a report in which they praised the British system and expressed confidence that the use of masters could be duplicated by the use of magistrates in our federal system to expedite the disposition of civil litigation.[37]

In 1976, Congress responded to these pressures by expanding the duties of the magistrates to allow them to perform pretrial and special master duties at the discretion of, and under the supervision of, the district court.[38] In the Senate Judiciary Committee hearings leading to the 1976 amendment of the Magistrates Act, the Commit-

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[33]*Magistrate Act of 1977: Hearings on S. 1612 and S. 1613 before the Sub-Comm. on Improvements in Judicial Machinery of Senate Comm. on the Judiciary*, 95th Cong., 1st Sess. 14 (1975) [hereinafter cited as *S. 1613 1612 & S. Hearings*] (statement of Peter G. McCabe).

[34]418 U.S. at 487 (Burger, C.J., dissenting).

[35]The Speedy Trial Act of 1974, 88 Stat. 2076 (1975) (codified in scattered sections of 18, 28 U.S.C.), has heightened the existing docket pressures and has required adjustments in court procedures and scheduling. The Speedy Trial Act has spurred the use of magistrates and will continue to do so.

[36]*See S. 1612 & S. 1613 Hearings*, *supra* note 33, at 14-17 (statement of McCabe).

[37]*Id.* at 47 (Exhibit B) (Report of Committee to Study the Role of Masters in the English Judicial System). *See S. 1612 & S. 1613 Hearings*, *supra* note 33, at 15 (statement of McCabe).

[38]Act of Oct. 21, 1976, Pub. L. No. 94-577, § 1, 90 Stat. 2729 (codified at 28 U.S.C.A. § 636(b) (Supp. 1978)).

tee made the observation that multi-tiered court systems have developed "simply in recognition of the fact that certain cases and judicial functions are of differing importance so as to justify different treatment by the court system."[39] The 1976 amendments to the Act dealt only with the "additional duty" jurisdiction of magistrates and the various means by which they could assist the judges.

For example, a magistrate may now *hear and determine* all pretrial matters in civil and criminal cases upon reference from a judge, except for eight enumerated case-dispositive motions: In criminal proceedings, a magistrate may not rule on (1) motions to dismiss or quash an indictment or information made by the defendant, or (2) motions to suppress evidence. In civil proceedings, a magistrate may not hear or determine (3) motions for injunctive relief (temporary restraining orders and preliminary injunctions), (4) motions to dismiss for failure to state a claim upon which relief may be granted, (5) motions to involuntarily dismiss an action (and the review of default judgements), (6) motions to dismiss or to permit the maintenance of a class action, (7) motions for judgment on the pleadings, or (8) motions for summary judgment. A magistrate may be assigned to hear and *recommend* disposition of any of the above motions, as well as applications to revoke probation, including the conduct of the final probation revocation hearing.[40]

A magistrate does *not* have the power to *determine dispositive matters.* Rather, he must prepare proposed findings and recommendations and file them with the court. A copy is thereupon mailed to the parties, who have ten days after receipt thereof within which to file specific objections in writing to the magistrate's report. The ultimate adjudication of the matter rests with the district judge to whom the entire case has been assigned. The judge must give "fresh" consideration to those issues as to which there have been specific objections. He must make a "de novo" determination, but he need not conduct a new hearing on the contested issues.[41]

In 1977, two Senate bills, S. 1612[42] and S. 1613,[43] were introduced to further enlarge magistrates' jurisdiction. S. 1612 was a recommendation of the Judicial Conference of the United States and is more limited in scope than S. 1613, which was drafted by the Department of Justice. Under existing law, the district courts may

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[39]*Jurisdiction of U.S. Magistrates*, S. Rep. No. 94-625, 94th Cong., 2d Sess. 6 (1976).

[40]*See* 28 U.S.C.A. § 636(b)(1)(A), (B) (Supp. 1978).

[41]*Id.* § 636(b).

[42]95th Cong., 1st Sess., *reprinted in S. 1612 & S. 1613 Hearings*, *supra* note 33, at 4.

[43]95th Cong., 1st Sess., 123 Cong. Rec. S12651 (daily ed. July 22, 1977).

designate magistrates to try and sentence persons accused of certain minor offenses for which the penalty "does not exceed imprisonment for a period of one year or a fine of not more than $1,000.00, or both."[44]

S. 1612, the Judicial Conference draft, would amend the definitions of a "minor offense" to include all misdemeanors when the penalty does not exceed imprisonment for period of one year or a fine of $5,000 or both.[45] The Judicial Conference has concluded that there are a number of misdemeanors in the United States Code not presently included in the term "minor offense" which could properly be tried by the magistrates.[46] These misdemeanors include the illegal possession of untaxed alcohol[47] and the illegal possession of certain controlled substances.[48]

Additionally, S. 1612 would eliminate the requirement, now found in 18 U.S.C. § 3401(b), that a defendant in a federal minor offense case may waive in writing his right to be tried by a district judge, as well as his right to trial by jury, and consent to be tried before a United States magistrate.[49] It is the view of the Judicial Conference that the present requirement of a written consent by the defendant to trial before a magistrate is constitutionally unnecessary and creates a needless administrative burden for the magistrate and his staff.[50]

S. 1612 would also make clear that the Juvenile Delinquency Act does not apply in "petty offense"[51] cases. The largest number of petty offenses are traffic violations committed within the federal enclaves, which are generally handled by United States magistrates.[52]

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[44]18 U.S.C. § 3401(f) (1976).

[45]S. 1612, 95th Cong., 1st Sess., *reprinted in S. 1612 & S. 1613 Hearings, supra* note 33, at 4. A "minor offense" is currently defined, with several exceptions, as a federal misdemeanor, the penalty for which does not exceed imprisonment for a period of one year or a fine of not more than $1,000 or both. 18 U.S.C. § 3401(f) (1976). The proposal does not affect misdemeanors other than "minor offenses," nor does it restrict any right that a defendant may have to a trial by jury.

[46]*See S. 1612 & S. 1613 Hearings, supra* note 33, at 28 (statement of McCabe).

[47]26 U.S.C. § 5686 (1970).

[48]21 U.S.C. § 841(b) (1976).

[49]18 U.S.C. § 3401(b) (1976). *See S. 1612 & S. 1613 Hearings, supra* note 33, at 28-29 (statement of McCabe), for a discussion of the waiver of consent requirement with reference to authorities on the subject.

[50]*S. 1612 & S. 1613 Hearings, supra* note 33, at 28-29.

[51]A "petty offense" is defined as a federal misdemeanor, the penalty for which does not exceed imprisonment for a period of six months or a fine of not more than $500. 18 U.S.C. § 1 (1976).

[52]The United States magistrates disposed of 103,061 minor and petty offense cases during fiscal year 1976, including 69,419 traffic cases, 13,231 illegal entry cases, and 6,511 violations of hunting, fishing, and camping regulations on federal lands. ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS, 1977 ANNUAL REPORT 289-90 (1977).

However, magistrates are without authority to conduct juvenile proceedings. At present, the Juvenile Delinquency Act does not clearly exempt petty offenses from the definition of "juvenile delinquency."[53] Application of the Act to petty offense cases currently requires juveniles who wish to have their cases conducted by a magistrate to undergo a complicated waiver procedure, which is generally unsatisfactory to all concerned. The proposed amendment would clearly allow magistrates to process petty offenses involving juveniles,[54] particularly traffic violations within federal enclaves.

S. 1613,[55] the bill recommended by the Department of Justice, while not as limited as S. 1612, is, however, like S. 1612, a logical extension of the original magistrate system. One purpose of the bill is to "improve access to the federal courts"[56] for all groups, especially the less advantaged, *e.g.*, the Social Security black lung disability claimants, and others seeking review of administrative agency decisions. Four major changes would be effected by S. 1613. First, the bill would remove the current $1,000 penalty ceiling on magistrates' criminal jurisdiction[57] and would delete current exemptions of certain offenses. Magistrates would then be able to try all misdemeanors. Second, a defendant charged with a misdemeanor carrying a penalty of six months' or less imprisonment, or a $500 fine, or both, would no longer be able to elect to have a trial before a district judge, but would be tried by a magistrate without a jury. If, however, the possible maximum punishment would exceed a $500 fine, or six months' imprisonment, or both, then either the defendant or the government would be given the election of a trial by jury before either the magistrate or the district court. Third, magistrates would be permitted to sentence under the Youth Correction Act. Fourth, appeals of right would be to the district court as to all decisions of the magistrate.

S. 1613 would explicitly give magistrates case-dispositive jurisdiction over all civil actions in which the district court and the parties concur as to such a disposition.[58] In this regard, the district court might promulgate a rule designating certain cases for magistrate determination. The bill would provide an appeal of right to the district court and further discretionary review by the court of appeals and the Supreme Court. The appeal to the district court would lie as to all factual and legal issues. The standard of review

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[53]Juvenile Delinquency Act, § 1, 18 U.S.C. § 5031 (1976).

[54]*S. 1612 & S. 1613 Hearings*, *supra* note 33, at 142.

[55]95th Cong., 1st Sess., 123 Cong. Rec. S12651 (daily ed. July 22, 1977).

[56]123 Cong. Rec. S12647 (daily ed. July 22, 1977).

[57]18 U.S.C. § 3401(f) (1976).

[58]S. 1613, 95th Cong., 1st Sess., 123 Cong. Rec. S12651 (daily ed. July 22, 1977).

would be the same as that employed by the court of appeals if the case had been initially litigated in the district court. Further appellate review by the court of appeals would be confined to discretionary review of matters of law decided by the district court.[59] In the interest of judicial economy, sponsors of the bill feel that no additional factual review is necessary or desirable. They point out that in many cases the administrative findings of fact would already have been reviewed twice—first by the magistrate and again by the district court.[60]

The court of appeals would grant or deny leave to appeal in much the same way it acts on a petition for allowance of appeal in some bankruptcy cases and interlocutory appeals.[61] Refusal to grant such an appeal would not be reviewable by the Supreme Court under the bill. Only determinations of law by the courts of appeals, made after the granting of leave to appeal, would be so reviewable. The bill provides, however, that the court of appeals may review any action when it appears from the petition for leave to appeal that a prejudicial error of law has been committed.[62]

A salient feature of S. 1613 is the provision requiring the Judicial Conference of the United States to fix standards and procedures for the judicial councils of the various circuits for the councils' use in preparing lists of persons deemed qualified to serve as United States magistrates. The district judges would then be required to appoint magistrates from the certified list.[63]

In hearings before the Subcommittee on Improvements in the judicial Machinery of the committee on the Judiciary of the United States Senate, Charles M. Metzner, the Chairman of the Committee on the Administration of the Magistrates System of the Judicial Conference, pointed out that magistrates are already empowered to hear and determine all civil litigation when the parties and the district court concur, including the use of jury trials for that purpose. Objection was voiced that it was unfair to permit the government the advantage of being able to elect whether it would try the more serious misdemeanor case before the magistrate, in a manner resembling the current defendant's election. Moreover, Metzner flatly declared that the bill would not work if the final judgment of the magistrate in civil cases was not appealable directly to the court of appeals. His view was that the parties would not agree to follow the more cumbersome and

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[59] S. 1613, 95th Cong., 1st Sess. § 2(c), 123 CONG. REC. S12651 (daily ed. July 22, 1977).

[60] 123 CONG. REC. S12650 (daily ed. July 22, 1977) (remarks of Sen. DeConcini).

[61] 28 U.S.C. § 1292 (1970).

[62] S. 1613, *supra* note 59.

[63] *Id.* § 3(a).

expensive route involving an initial appeal to the district court and a subsequent appeal to the court of appeals. He observed that although the sponsors of the bill had sought to relieve appellate pressure by having the district court review the magistrates' final judgments in the first instance, it was unlikely that litigants would accept the more expensive and time-consuming route to final judgment following the appellate review. Additionally, he expressed the view that the procedure for appeal to the district court may very well dampen the enthusiasm for the suggested improved access to the federal courts. He noted that these cases are presently being tried by the district courts with the right of appeal to the court of appeals.[64]

B. The Petit Jury

In recent years, efforts to streamline the disposition of civil litigation in federal courts has focused on the modification or outright elimination of the use of petit juries in civil cases. Although only a few years ago the subject was roundly debated, today, however, the debate in federal circles has all but ceased with the adoption of civil juries of less than twelve in nearly all the federal districts. At last count, the use of juries of less than twelve had been adopted in 87 of the 94 districts; a few still require eight-member juries.[65]

Those favoring abandonment of juries in civil cases point to the British system and contend that the virtual elimination of civil juries in the Mother Country has not diminished the quality of justice. They argue that bench trials are less costly and time-consuming, and that the awards are more predictable in comparable cases. On the other hand, those supporting the retention of civil juries argue the positive points of the jury system as an institution. As pointed out by Professor Hans Zeisel at the Annual Chief Justice Earl Warren Conference on Advocacy in the United States, these positive points are that:

> (1) the jury provides an important civic experience for the citizen;
> (2) because of popular participation, the jury makes tolerable the stringency of certain decisions;

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[64] *S. 1612 & S. 1613 Hearings, supra* note 33, at 12-14 (statement of Hon. Charles M. Metzner, Judge, United States District Court for the Southern District of New York, and chairman of the Committee on the Administration of the Magistrates System of the United States Judicial Conference).

[65] This statistic was supplied by Hon. Edward Devitt, Chief Judge, United States District Court for the District of Minnesota, and co-author of E. Devitt & C. Blackmar, Federal Jury Practice & Instructions (3d ed. 1977).

> (3) because of its transient personnel, the jury acts as a sort of lightning rod for animosity and suspicion which otherwise might center on the more permanent judge; and
> (4) the jury is a guarantor of integrity, since it is said to be more difficult to reach twelve men than one.[66]

Professor Zeisel stresses that

> [t]he Anglo-American jury is a remarkable political institution. We have had it with us for so long that any sense of surprise over its main characteristics has perhaps somewhat dulled. [The jury institution] recruits a group of twelve laymen, chosen at random from the widest population; it convenes them for the purpose of the particular trial; it entrusts them with great official powers of decision; it permits them to carry on deliberations in secret and to report out their final judgment without giving reasons for it; and, after their momentary service to the state has been completed, it orders them to disband and return to private life. The jury represents a deep commitment to the use of laymen in the administration of justice—a commitment that finds its analogue in the widespread use of lay judges in the criminal courts of other countries.[67]

There was a time when I too favored abandonment of civil juries. However, in more recent years I have come around full circle to the conclusion that the petit jury system is too much a part of our legal order to be abandoned, even in civil trials. As so eloquently stated by Alexis de Tocqueville: "It would be a very narrow view to look upon the jury as a mere judicial institution; for, however great its influence may be upon the decision of the courts, it is still greater on the destinies of society at large."[68]

In my own experience, I have found, as I am sure other judges have found, that trial by jury often achieves faster results than a trial to the court without a jury, especially in cases that must be taken under advisement while the court ponders the evidence, considers the post-trial briefs, and makes its findings and conclusions. I do not foresee the use of less than twelve-member juries in criminal cases in the federal trial courts.

C. The Grand Jury

Changes which pending legislation would make in the grand jury system may also have significant impact on the federal district

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[66]Zeisel, *The American Jury*, in THE AMERICAN JURY SYSTEM 65, 67 (1977) (published by the Roscoe Pound—American Trial Lawyers Foundation).

[67]*Id.* at 66.

[68]Bennett & Koskoff, *Foreward* to THE AMERICAN JURY SYSTEM, *supra* note 66, at 11 (quoting de Tocqueville).

courts. Among the changes which would be worked by the proposed Grand Jury Reform Act of 1977, H.R. 94,[69] and which would have impact on the courts as well as prosecutorial authorities, is the switch from use immunity to transactional immunity. The bill would also allow a grand jury witness to have counsel present during testimony before a grand jury and would allow counsel to disclose what had transpired during his presence. The size of the federal grand juries would, under the Reform Act, be lessened from the present minimum of sixteen and maximum of twenty-three to a minimum of nine and a maximum of fifteen. The Act would impose additional instruction and supervision burdens upon the district courts, while requiring new procedures regarding subpoenaes, notice thereof, and the quashing and clarifying of subpoenaes.[70]

D. Diversity Jurisdiction

One of the areas of federal jurisdiction which is often examined when reform of the federal judicial system is considered is diversity-of-citizenship jurisdiction.

On February 28, 1978, a bill to abolish diversity of citizenship as a basis of federal district court jurisdiction was passed by the House of Representatives. The bill, H.R. 9622,[71] provides for the amendment of the diversity statute by striking the words "citizens of different States," but would not affect the language conferring upon the district courts original jurisdiction of civil actions where the matter in controversy exceeds $10,000 and is between citizens of a state and citizens of a foreign state, or between a foreign state as plaintiff and citizens of a state or different states.

Although the bill as passed by the House would retain alienage jurisdiction under 28 U.S.C. § 1332,[72] it would, however, raise the jurisdictional amount from $10,000 to $25,000.[73] The bill would also abolish the requirement that there be $10,000 in controversy in federal question cases. Congress amended 28 U.S.C. § 1331 in 1976 to provide that no amount in controversy is required in any federal question case brought against the United States;[74] however, the amount-in-controversy requirement still applies in a small number of federal question cases. The elimination of the amount-in-controversy requirement in these federal question cases would not have an appreciable effect on the federal caseload. As amended by the bill, section 1331 would provide: "The district courts shall have original

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[69] 95th Cong., 1st Sess. (1977).

[70] *Id.*

[71] 95th Cong., 2d Sess., 124 CONG. REC. H1553 (daily ed. Feb. 28, 1978).

[72] 28 U.S.C. § 1332(a)(2) (1970).

[73] H.R. 9622, *supra* note 71, § 1(a).

[74] 28 U.S.C.A. § 1331 (Supp. 1978).

jurisdiction of all civil cases wherein the matter in controversy arises under the Constitution, laws, or treaties of the United States."[75]

The bill retains statutory interpleader[76] as a basis for federal jurisdiction. The House Report accompanying the bill stated that this is a recognition that section 1335 interpleader "serves a valuable function, providing a federal forum for suits in which no single state court could obtain jurisdiction and in which there are widely scattered, competing claimants."[77]

Whether the bill passes the Senate remains to be seen. My guess is that the bill will encounter a less favorable reception in the Senate. It must be remembered that the bill was passed by the House under a suspension of the rules, the bill having been placed on the suspension calendar where normally noncontroversial issues are placed to get rid of them.

One member of the House, Congressman Glickman from Kansas, found it absolutely incredible that a bill of its magnitude was being passed under a suspension of the rules. He felt there were times when members of the House had their priorities mixed up. He stated,

> We spend hours on noncontroversial pieces of legislation in the full House and then we get a bill like this that has a monumental impact on our judicial system and we have 40 total minutes time to debate it. We cannot even amend the bill on the floor and we are asked to make this kind of review.[78]

He hoped the suspension of the rules would be beaten so as to bring the bill back to the House for full discussion and with a variety of amendments. It concerned him greatly that the House was considering the bill which, in his words, "directly relates to provisions of the Constitution."[79] Diversity, he stated, has served as a basis for federal jurisdiction for nearly 200 years, and he did not think the House "should decide to do away with it without the benefit of full floor debate and amendment."[80]

It was incredible to Congressman Glickman that the bill was being considered in such a manner, for, in talking to lawyers throughout the country as one of his colleagues from Missouri had

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[75]H.R. 9622, *supra* note 71, § 2(a).

[76]28 U.S.C. § 1335 (1976).

[77]*Abolition of Diversity of Citizenship Jurisdiction*, H.R. REP. NO. 95-893, 95th Cong., 2d Sess. 8 (1978).

[78]124 CONG. REC. H1556-57 (daily ed. Feb. 28, 1978).

[79]*Id.* at H1557.

[80]*Id.*

done, it was found that attorneys generally knew nothing about the bill. He claimed that they were shocked to find out what was happening on the floor of the House and that none of them knew anything about the fact that the legislation would shift the "bulk load" of litigation to the state courts. There had been no testimony or findings in the committee reports that dealt with the issue of the *quality* of justice in a transfer of this "great bulk load of cases to the state courts." He argued that the House had just created an additional 140 judges. Further, he questioned whether we would have a more efficient system "just in the type of decision made by the State judges"[81] by adding the additional federal judges and then taking away a substantial percentage of their caseload.

Previously, in addition to the above remarks, Congressman Glickman has urged the following five points upon his colleagues in favor of retaining diversity jurisdiction in some instances, particularly in the large urban areas, where the backlog of cases pending before the state courts was greater than those before the federal courts: (1) A reduction of congestion in the federal system would merely shift that congestion to the state system without any kind of advance analysis; (2) the House Judiciary Committee has unequivocally stressed its concern about the quality of justice in our system of justice, but there was no indication that the bill analyzed factors other than efficiency in any detail; (3) the House had just approved bankruptcy legislation giving relief to the federal courts; (4) state courts, unlike federal courts, cannot generally enforce their decisions beyond their jurisdictional boundaries; (5) the elimination of diversity jurisdiction could pose serious jurisdictional problems with reference to venue statutes and create "unnecessary inconvenience" in others.[82]

Certainly there are persuasive arguments in favor of removing diversity jurisdiction from the federal district courts. It would, in the words of the Chief Justice, be a great step toward achieving "a proper balance . . . between the federal and state court systems."[83] It would also turn back nearly 32,000 cases from 400 federal district judges to some 6,000 state trial judges,[84] thereby having a substantial impact in saving federal courts from insidious court congestion and allowing the federal courts to resolve disputes in traditional federal subject matter areas basic to civil and constitutional rights.

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[81]*Id.*

[82]*Id.*

[83]*State of the Judiciary and Access to Justice: Hearings Before the Subcomm. on Courts, Civil Liberties, and the Administration of Justice of the House Comm. on the Judiciary*, 95th Cong., 1st Sess. 7 (1977) (statement of Chief Justice Warren E. Burger (quoting Chief Justice Earl Warren)).

[84]124 CONG. REC. H1554 (daily ed. Feb. 28, 1978).

The state courts are capable of providing a fair and impartial forum in these cases. In 1977, the Conference of Chief Justices stated, "Our State court systems are able and willing to provide needed relief to the Federal court system, [including] . . . [t]he assumption of all or part of the diversity jurisdiction presently exercised by the Federal courts."[85] Modern benefits of diversity jurisdiction are hard to discern. The historic argument in favor of the use of diversity—that is, the potential for bias in state courts and state legislatures—was derived from a time in our history when regional feelings were far stronger. Diversity cases involving questions of state law would be resolved in state courts and federal law questions would be adjudicated in federal courts, regardless of the amount in controversy.

The legislation received broad-based support from individuals and organizations interested in improving the administration of justice in both the federal and state judicial systems. To be specific, as stated by Congressman Kastenmeier of Wisconsin, H.R. 9622 is enthusiastically supported by the Conference of State Chief Justices, the Judicial Conference of the United States, the National Senior Citizens Law Center, the NAACP Legal Defense and Education Fund, the American Civil Liberties Union, the Department of Justice Committee on Revision of the Federal Judicial System and the Department of Justice itself, the Legal Services Corporation, the American Bar Association Committee of Coordination of Federal Judicial Improvements, and the Council on Public Interest Law. Congressman Kastenmeier notes that the list of individuals who expressed support for the legislation reads like an index of "Who's Who in American Law" and includes Professor and former Solicitor General Robert Bork, Professor Charles Alan Wright, Dean Erwin Griswold, Chief Justice Warren Burger, Attorney General Griffin Bell, and Judge Shirley Hufstedler.[86]

E. Civil Arbitration

While innovations in the Magistrates system have helped to relieve some of the pressures on the district courts, another plan has been introduced in Congress which could aid in processing civil cases in the federal district courts.

Last October, Congressman Peter Rodino, Chariman of the House Committee on the Judiciary, introduced H.R. 9778,[87] a bill to amend title 28 of the United States Code in order to encourage prompt, informal, and inexpensive resolution of civil cases by the

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[85]Resolution of the Conference of Chief Justices (Aug. 30, 1977), *reprinted in* H.R. Rep. No. 95-893, *supra* note 64, at 21.

[86]124 Cong. Rec. H1554 (daily ed. Feb. 28, 1978).

[87]95th Cong., 1st Sess. (1977).

use of arbitration in the United States district courts. The bill would allow any district to adopt arbitration for the resolution of certain types of private cases, as well as cases involving the government where the Attorney General has provided by regulation that they should be submitted to arbitration. The bill limits money damages to $50,000. It also provides that arbitration shall be implemented on a test basis for three years in no fewer than five nor more than eight representative districts to be designated by the Chief Justice, after consultation with the Attorney General. The Judicial Conference would be authorized to develop model procedures under the Act. The Federal Judicial Center is to advise and consult with the Judicial Conference and the district courts in connection with their duties under the Act. Finally, the Federal Judicial Center, in consultation with the Attorney General and the Administrative Office of the United States Courts, is to transmit to Congress, on or before the expiration of three years from the effective date of the Act, a report on the use, effectiveness, and benefits of arbitration in the test districts and such other districts in which cases are referred to arbitration under the Act.[88]

Recently the Justice Department announced that three federal district courts are implementing pilot programs in cooperation with the Judicial Center and the Department of Justice to test the effectiveness of arbitration in those districts. The program was commenced in the District of Connecticut and the Northern District of California on April 1, 1978. The program had already been commenced in the Eastern District of Pennsylvania at Philadelphia. In each of these districts under the plans adopted, arbitration is to be applied in most personal injury cases, property damage, and contract cases, involving, in the Eastern District of Pennsylvania, not more than $50,000, and, in the District of Connecticut and the Northern District of California, not more than $100,000. Under the local plans adopted by the pilot program district courts, arbitration is mandatory but nonbinding. The parties may reject the procedure after the clerk has referred the case to a panel of arbitrators and has asked for a trial de novo. This may be done even after the entry of judgment on the award has been entered, provided the request for trial de novo has been made within the specified time. Otherwise, the judgment stands and there is no appeal from it.[89]

IV. Summary

In conclusion, I would like to recap eight areas covered in my remarks on the future of the federal district courts. First, as I envi-

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[88] *Id.*

[89] *See* Administrative Office of the United States Courts, Report of the Proceedings of the Judicial Conference of the United States 6 (1978).

sion the future of the federal district courts, barring surprise events that could change the entire course of history, I see the courts in a supertechnological environment, and, I might add, an intrinsically dangerous environment, with an urban population of 275 million, as compared to a rural population of 4 million in 1790, a demographic and ecological environment far different from that from which came those who ratified our Constitution and Bill of Rights. Our interdependent social and economic order will be continually more vulnerable to disruption, causing increased numbers to seek the courts to resolve their disputes.

Second, following the pattern of the past thirty years, if Congress responds with more judgeships, based on unofficial figures projected by the Administrative Office of the United States Courts, the number of district judges in the year 2000 will have grown from the present 401 to 880, with an annual combined civil and criminal caseload of 288,000, or 327 cases per judgeship.[90]

Third, I see the role of the United States magistrate emerging prominently, both in respect to their number and their powers. By the twenty-first century, their number and their authority will have been greatly increased, and far more of the district judges' responsibilities will have been shifted to them. The ratio of full-time magistrates to district judges will have increased greatly—even to the point where the magistrates will outnumber the district judges.

The reviewing responsibilities of the district judge will have increased greatly, both as to administrative tribunal rulings through suits for the purpose and as to rulings of magistrates, arbitrators, special masters, and probably rulings of bankruptcy judges. While the bankruptcy court may be made a separate court from the district court, I doubt seriously that direct appeal from the bankruptcy court to the court of appeals will be permitted.

Thus, I believe that the number of baseline adjudicators without article III powers will have been increased greatly, but the number of article III nontenured district judges will have been increased only sparingly. In other words, the supporting base of the federal judicial system will have been broadened horizontally, but without a corresponding broadening of the tier of district courts above it in the judicial pyramid. This conclusion seems apparent, for not only is it less costly to increase the number of magistrates than it is to increase the number of district judges, but it is also far less inconvenient. By spreading the caseload to a broader base below with intermediate review by the district court, an appreciable amount of appellate pressure on the appellate courts can be avoided. Caseload pressure must first be relieved below, not only to afford greater ac-

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[90]*See* text accompanying note 24 *supra*.

cess to the trial courts, but to maintain efficiency in, and our awesome respect for, the higher courts.

Fourth, the petit jury system will remain largely as it is today—twelve-member juries in criminal cases, and less than twelve-member juries in civil cases in all but a few districts, if not in all of them. In other words, the civil jury will not be abandoned in exchange for bench trials, as some would have it. There was a time when I too favored abandonment of civil juries. However, in more recent years I have come around full circle to the conclusion that the petit jury system is too much a part of our legal order to be abandoned, even in civil trials.

Fifth, I see in the future a limited reform in the federal grand jury system. The grand jury, I believe, will be reduced in number from the present required minimum of sixteen and maximum of twenty-three, to perhaps a minimum of nine and a maximum of fifteen, as presently proposed in Congress. Subject to well-defined restrictions, I believe witnesses before the grand jury will some day be allowed to have counsel with them when called to produce information or testify, largely as witnesses are permitted to be represented by counsel in congressional and other investigatory hearings today.

Sixth, although there are persuasive arguments for and against the abolition of diversity of citizenship as a basis for federal district court jurisdiction, I find it difficult to believe that the bill that has passed the House of Representatives will receive the same favorable reception in the Senate that it received in the House. I believe that the effects of the bill's passage on the nation's system of justice in the state and federal courts will receive very critical analysis in the Senate before it is passed in its present form. The relief it would bring to the federal courts' caseload would be welcomed by the federal judiciary, but serious questions are presented as to the effect it will have on some state court backlogs, especially in the larger urban areas.

Seventh, as a means to achieve prompt, informal, and inexpensive resolution of civil cases, mandatory civil arbitration will be widely, if not universally, adopted in the federal district courts.

Finally, I see for the federal courts, both trial and appellate, vastly enlarged central staffs of supporting research personnel, including screening personnel, staff attorneys, law clerks, and other para-judicial personnel, to handle the overwhelming cascade of paperwork flowing upon the federal courts, much of which will be cases filed by individuals acting pro se. National research data centers will serve each of the federal courts to enable them to keep momentarily abreast of the latest appellate and Supreme Court decisions.

Notes

Reasonable Cause for the Late Filing of Estate Tax Returns

If a federal estate tax return is required, it must be filed within nine months of the decedent's death.[1] A late return is subject to penalties based on the amount of tax and length of delay.[2] Fines will be imposed unless the taxpayer establishes that the delinquency was due to reasonable cause, and not to willful neglect.[3] Although the executor is technically responsible for filing,[4] his attorney generally prepares and mails the return.[5] Thus, a dilatory lawyer may find himself faced with an outraged executor on one hand and penalties that exceed his fees on the other. In order to avoid a possible malpractice suit, the legal representative may decide to assume

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[1]"Returns made under section 6018(a) . . . shall be filed within 9 months after the date of the decedent's death." I.R.C. § 6075(a). Prior law required that an estate tax return be filed within 15 months after the date of death. Int. Rev. Code of 1954, ch. 61, § 6075(a), 68A Stat. 751.

"In all cases where the gross estate at the death of a resident or citizen exceeds $175,000, the executor shall make a return with respect to the estate tax . . . ." Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(c)(1)(J), 90 Stat. 1520. The current section relates to decedents dying after December 31, 1976, with transitional requirements of filing an estate tax return if the gross estate exceeds $120,000, $134,000, $147,000, or $161,000 for decedents dying in 1977, 1978, 1979, and 1980 respectively. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(c)(1)(J), 90 Stat. 1520. Prior law required the filing of an estate tax return if the gross estate exceeded $60,000. Int. Rev. Code of 1954, ch. 61, § 6018(a), 68A Stat. 739. All cases discussed herein involve the prior law because no cases have been reported since the effective date of the current law.

[2]If a return is delinquent, a penalty of 5% per month (or fraction thereof) may be imposed to a maximum of 25% of the net estate tax. I.R.C. § 6651(a)(1). In Estate of Krampf v. Commissioner, 56 T.C. 293 (1971), *aff'd per curiam*, 72-2 U.S. Tax Cas. 86,079 (3d Cir. 1972), the court stated that the penalty should be based on the correct tax liability, rather than on the amount of tax shown on the return (citing Fisher v. Commissioner, 50 T.C. 164 (1968)). In *Krampf*, the return was filed 12 days late and the taxpayer introduced no evidence on the issue of reasonable cause.

The failure to file penalty is reduced to 4½% per month if a failure to pay penalty is also in effect for the period. Treas. Reg. § 301.6651-1, T.D. 7133, 1971-2 C.B. 415.

The failure to pay penalty is ½% each month (or fraction thereof) to a maximum of 25% I.R.C. § 6651(a)(2).

[3]I.R.C. § 6651(a)(1), (2).

[4]*See* note 1 *supra*. "The term 'executor' . . . means the executor or administrator of the decedent, or, if there is no executor or administrator appointed, qualified, and acting within the United States, then any person in actual or constructive possession of any property of the decedent." I.R.C. § 2203.

[5]*See, e.g.*, United States v. Kroll, 547 F.2d 393 (7th Cir. 1977); Estate of Campbell v. United States, 77-2 U.S Tax Cas. 88,665 (D.N.J. Oct. 12, 1977); Richter v. United States, 77-2 U.S. Tax Cas. 88,649 (D. Minn. Oct. 3, 1977).

the liability for the penalties himself. Therefore, the methods of eliminating that extra expense are of interest.

Penalties for late filing may be avoided in four ways. First, a complete return can be filed by the original due date.[6] Second, an extension of time may be obtained and a complete return filed before the expiration thereof.[7] Third, a return as complete as possible can be filed within the above periods.[8] Finally, no penalty will be imposed if reasonable cause for late filing is established. This discussion will focus on the circumstances which do or do not constitute sufficient reason for delinquency according to the courts that have examined the issue.[9]

Reasonable cause has been defined as the exercise of ordinary

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[6]Estate tax returns that are timely mailed (as indicated by the postmark) are considered filed on the day mailed. *See* I.R.C. § 7502. If a return is mailed after the due date, however, it is not filed until it is received by the Internal Revenue Service. Rev. Rul. 73-133, 1973-1 C.B. 605. Thus, if a return was due on December 14, was mailed on January 13, and was received on January 15, the return would be treated as over one month late and a 10% penalty would be incurred unless reasonable cause for the delay was shown.

[7]I.R.C. § 6081(a).

[8]If in any case the executor is unable to make a complete return as to any part of the gross estate, he is required to give all of the information he has as to such property, including a full description, and the name of every person holding a legal or beneficial interest in the property.

Treas. Reg. § 20.6018-2 (1958).

[9]This Note will examine all decisions rendered prior to January 1, 1978, involving I.R.C. § 6651 and estate tax returns. The opinions in Estate of Krampf v. Commissioner, 56 T.C. 293 (1971), *aff'd per curiam*, 72-2 U.S. Tax Cas. 86,079 (3d Cir. 1972) (*see* note 2 *supra*), and Estate of Rackett v. Commissioner, 35 T.C.M. (CCH) 530 (1976), are the only ones involving I.R.C. § 6651 and estate tax in which reasonable cause was not alleged by the taxpayer. In *Estate of Rackett*, the estate was assessed penalities based upon the amount of tax shown on the return. Such amount was paid by check with a written statement that said check constituted satisfaction of all liability. After an audit, additonal tax and penalties on that deficiency were determined and a statutory notice was sent to the taxpayer. The personal representative contended that the Internal Revenue Service could not increase the tax and penalties after the original billing. The court found that the actions taken by the government were permissible.

In addition, the Internal Revenue Service has administratively determined that in certain circumstances no penalties will be imposed if: (1) A return is mailed within the time for filing, but is received by Internal Revenue after the due date: (2) a return is mailed timely to the wrong district; (3) a failure to file is caused by erroneous information from an Internal Revenue Service employee; (4) the failure is due the unavoidable absence of the taxpayer; (5) fire or other casualty destroys the taxpayer's place of business or business records; (6) the taxpayer demonstrates an inability to obtain the necessary forms from Internal Revenue; (7) the taxpayer personally visits an Internal Revenue office and through no fault of his own is unable to meet with an Internal Revenue Service representative; or (8) a failure to file is caused by death or serious illness of the taxpayer or serious illness in his immediate family. INTERNAL REVENUE SERVICE, INTERNAL REVENUE MANUAL § 4562.2 (1976).

business care and prudence.[10] An absence of willful neglect is not adequate.[11] Imposition of the penalty is mandatory unless satisfactory reasons for delay are shown.[12] Whether certain circumstances are sufficient is a question of fact,[13] and the executor has the burden of proof[14] by a preponderance of the evidence.[15]

The most often raised question in this context is whether reliance on counsel constitutes reasonable cause. This issue will be

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[10]Treas. Reg. § 301.6651-1, T.D. 7133, 1971-2 C.B. 415. *See also* Northwestern Nat'l Bank v. United States, 72-2 U.S. Tax Cas. 86,006 (D.S. Dak. 1972); Pfeiffer v. United States, 315 F. Supp. 392 (E.D. Cal. 1970); James v. United States, 65-1 U.S. Tax Cas. 95,601 (E.D. Va. 1964); Estate of Duttenhofer v. Commissioner, 49 T.C. 200 (1967), *aff'd per curiam*, 410 F.2d 302 (6th Cir. 1969); Estate of Mayer v. Commissioner, 43 T.C. 403 (1964), *aff'd per curiam*, 351 F.2d 617 (2d Cir. 1965), *cert. denied*, 383 U.S. 935 (1966); Estate of DeVos v. Commissioner, 34 T.C.M. (CCH) 933 (1975); Estate of Klein v. Commissioner, 34 T.C.M. (CCH) 567 (1975); Estate of Moesch v. Commissioner, 33 T.C.M. (CCH) 1271 (1974); Estate of Crute v. Commissioner, 33 T.C.M. (CCH) 1073 (1974); Estate of Geraci v. Commissioner, 32 T.C.M. 424 (1973), *aff'd per curiam*, 502 F.2d 1148 (6th Cir. 1974), *cert. denied*, 420 U.S. 992 (1975); Estate of Plotkin v. Commissioner, 31 T.C.M. (CCH) 1011 (1972); Estate of Lewis v. Commissioner, 22 T.C.M. (CCH) 1732 (1963).

[11]Estate of Klein v. Commissioner, 34 T.C.M. (CCH) 567 (1975); Estate of Moesch v. Commissioner, 33 T.C.M. (CCH) 1271 (1974); Estate of Crute v. Commissioner, 33 T.C.M. (CCH) 1073 (1974); Estate of Geraci v. Commissioner, 32 T.C.M. (CCH) 424 (1973), *aff'd per curiam*, 502 F.2d 1148 (6th Cir. 1974), *cert. denied*, 420 U.S. 992 (1975); Estate of Plotkin v. Commissioner, 31 T.C.M. (CCH) 1011 (1972); Estate of Lewis v. Commissioner, 22 T.C.M. (CCH) 1732 (1963).

[12]Estate of Hollenbeck v. United States, 72-2 U.S. Tax Cas. 86,109 (D. Col. 1972); Estate of Geraci v. Commissioner, 32 T.C.M. (CCH) 424 (1973); *aff'd per curiam*, 502 F.2d 1148 (6th Cir. 1974), *cert. denied*, 420 U.S. 992 (1975).

[13]Giesen v. United States, 369 F. Supp. 33 (W.D. Wis. 1973); Estate of Duttenhofer v. Commissioner, 49 T.C. 200 (1967), *aff'd per curiam*, 410 F.2d 302 (6th Cir. 1969); Estate of Crute v. Commissioner, 33 T.C.M. (CCH) 1073 (1974); Estate of Bradley v. Commissioner, 33 T.C.M. (CCH) 70 (1974), *aff'd*, 511 F.2d 527 (6th Cir. 1975); Estate of Geraci v Commissioner, 32 T.C.M. (CCH) 424 (1973), *aff'd per curiam*, 502 F.2d 1148 (6th Cir. 1974), *cert. denied*, 420 U.S. 992 (1975); Estate of Plotkin v. Commissioner, 31 T.C.M. (CCH) 1011 (1972); Estate of Lewis v. Commissioner, 22 T.C.M. (CCH) 1732 (1963).

[14]United States v. Mize, 73-1 U.S. Tax Cas. 81,303 (C.D. Cal. 1972); Northwestern Nat'l Bank v. United States, 72-2 U.S. Tax Cas. 86,006 (D.S. Dak. 1972); Pfeiffer v. United States, 315 F. Supp. 392 (E.D. Cal. 1970); James v. United States, 65-1 U.S. Tax Cas. 95,601 (E.D. Va. 1964); Estate of Klein v. Commissioner, 34 T.C.M. (CCH) 567 (1975); Estate of Crute, 33 T.C.M. (CCH) 1073 (1974); Estate of Plotkin v. Commissioner, 31 T.C.M. (CCH) 1011 (1972); Estate of Pridmore v. Commissioner, 20 T.C.M. (CCH) 47 (1961).

[15]United States v. Mize, 73-1 U.S. Tax Cas. 81,303 (C.D. Cal. 1972); James v. United States, 65-1 U.S. Tax Cas. 95,601 (E.D. Va. 1964). The reported decision in *James* is in the form of jury instructions that include the preponderance of the evidence standard and the jury's verdict. Since few facts are indicated, the only conclusion that can be drawn is that the administrator failed to meet the burden of proof required to establish that he acted as an ordinary, prudent business man in filing the return three to four months late.

examined in terms of advice regarding whether a return is required and advice regarding when a return is due.

I. Reliance on Counsel—Regarding Whether a Return Is Required

The opinion rendered in *Estate of Christ v. Commissioner*[16] is the only estate tax decision centering on this issue. Christ died on December 2, 1961, and the return was due on March 2, 1963. The taxpayer contended that he "always relied on his attorney's advice with respect to what tax returns should be filed and when they should be filed. . . . [H]is legal counsel advised that no estate tax return should or need be filed because Daisy's gross estate was less than the specific exemption of $60,000 . . . ."[17] According to the Internal Revenue Service, the several attorneys for the estate should have been on notice that a return would be required. The court found that the attorney in good faith believed that no tax was due[18] and noted that the executor had no reason to doubt the competence of his attorney. The court held that, since his reliance on counsel was reasonable and justified, no penalties should be imposed,[19] citing *Portable Industries v. Commissioner*,[20] *Twinam v. Commissioner*,[21] and *Patino v. Commissioner*.[22]

Dependence on an accountant was determined to be reasonable cause for failure to file personal holding company returns in *Haywood Lumber & Mining Co. v. Commissioner*.[23] Although *Haywood* is not an estate tax case, it is significant because of its citation by plaintiffs in estate tax cases.[24]

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[16]54 T.C. 493 (1970), *aff'd on other grounds*, 480 F.2d 171 (9th Cir. 1973).

[17]*Id.* at 553.

[18]"Petitioner's failure to file timely the estate tax return for decedent was due to reasonable cause and not due to willful neglect, where he was advised by his attorney in good faith that no return need be filed because no estate tax was due." *Id.* at 523. *Compare* Estate of Plotkin v. Commissioner, 31 T.C.M. (CCH) 1011 (1972), where the court suggested that, if the gross estate clearly exceeds the amount required for filing, professional advice that no tax is due does not constitute reasonable cause, *with Estate of Christ.*

[19]54 T.C. at 554.

[20]24 T.C. 571 (1955). In *Portable Industries*, the court held that the lawyer's advice that the taxpayer was not a personal holding company was reasonable cause for not filing those returns.

[21]22 T.C. 83 (1954). In *Twinam*, the attorney's advice that alimony payments were not taxable was deemed sufficient reason for petitioner's failure to file income tax returns.

[22]13 T.C. 816 (1949), *aff'd on other grounds*, 186 F.2d 962 (4th Cir. 1950). In *Patino* the court held that a lawyer's'advice that a taxpayer was a nonresident alien and need not file income tax returns was adequate to avoid penalties.

[23]178 F.2d 769 (2d Cir. 1950), *rev'g* 12 T.C. 735 (1949).

[24]Giesen v. United States, 369 F. Supp. 33 (W.D. Wis. 1973); Estate of Duttenhofer v. Commissioner, 49 T.C. 200 (1967), *aff'd per curiam*, 410 F.2d 302 (6th Cir. 1969);

In *Haywood*, a corporate officer asked a certified public accountant to prepare "the proper corporate tax returns."[25] The accountant knew that the business was a personal holding company, but failed to inform the officer or to file the required returns. The Tax Court held that there was no reasonable cause since the officer had passively awaited the preparer's advice. In reversing that decision, the Second Circuit Court of Appeals stated: "When a corporate taxpayer selects a competent tax expert, supplies him with all necessary information and requests him to prepare the proper tax returns, we think the taxpayer has done all that ordinary business care and prudence can reasonably demand."[26] The practitioner in *Haywood* had twenty years of experience and had advised the taxpayer previously. The court refused to impute the negligence of the accountant to the company because the company would have then been held to a standard of care that was higher than that generally required of laymen.[27]

The court in *Commissioner v. American Association of Engineers Employment*[28] quoted the test set forth in *Haywood* in finding that reliance on an attorney was reasonable cause.[29] The taxpayer's counsel, who had specialized in taxation for twenty-five years, advised the taxpayer that it was an exempt organization not required to file tax returns. *American Association of Engineers Employment* is of particular interest because of its treatment in subsequent Seventh Circuit cases.[30]

II. Reliance on Counsel—Regarding When a Return Is Due

The cases discussed below involve situations in which the gross estate clearly exceeds the statutory minimum for filing. The question is whether an executor's dependence on a professional (either attorney or accountant) establishes reasonable cause for failure to file such return within the prescribed time.[31]

Various circuits will be considered separately, since they have developed different positions on the matter. To demonstrate the

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Estate of Mayer v. Commissioner, 43 T.C. 403 (1964), *aff'd per curiam*, 351 F.2d 617, (2d Cir. 1965), *cert. denied*, 383 U.S. 935 (1966); Estate of Lewis v. Commissioner, 22 T.C.M. (CCH) 1732 (1963).

[25]178 F.2d at 770.

[26]*Id.* at 771.

[27]*Id.*

[28]204 F.2d 19 (7th Cir. 1953).

[29]*Id.* at 21.

[30]United States v. Kroll, 547 F.2d 393 (7th Cir. 1977); Giesen v. United States, 369 F. Supp. 33 (W.D. Wis. 1973).

[31]The applicable time limit in those cases is 15 months. Int. Rev. Code of 1954, ch.61, § 6075(a), 68A Stat. 751.

historical development of the law, the cases within a circuit will be discussed chronologically. The circuits are arranged in a similar order, starting with the one whose most recent decision is the oldest. The latest opinion will be the final one analyzed.[32]

A. Ninth Circuit

The holding in *Ferrando v. United States*[33] was based on the delinquency penalty section of the Internal Revenue Code of 1939.[34] *Ferrando* is not the only case decided under the prior section, but is included herein because it was the first case to hold that an executor cannot delegate his duty of timely filing an estate tax return to his attorney. The inexperienced taxpayers (widow and son of the decedent) entrusted the entire administration of the estate to an attorney and made no attempt to ascertain their duties as executors. The preparer said that the late filing was caused by the pressure of his business and an indefinite oral extension of time from a Deputy Collector of the Internal Revenue Service.[35] After noting that a personal representative must see to it that his counsel is diligent, the court determined that the taxpayer has a positive obligation to learn the due date of the return.[36]

A companion case to *Ferrando*, *Ferrari v. United States*,[37] involved the same attorney and other executors who were inexperienced with

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[32]Tax Court decisions are reviewable by the United States Court of Appeals for the district in which the taxpayer has his legal residence. I.R.C. § 7482. Therefore, they are discussed under the heading of the approprate circuit because the Tax Court will presumably follow the holdings of that circuit.

[33]56-2 U.S. Tax Cas. 56,871 (N.D. Cal. 1956), *aff'd*, 245 F.2d 582 (9th Cir. 1957).

[34]Int. Rev. Code of 1939, ch. 34, § 3612(d), 53 Stat. 438 (now I.R.C. § 6651).

[35]The attorney testified, "I was then told to bring in the return when I did have time to prepare it and file it. I consider that [quite unilaterally!] an indefinite extension of time to file it." Ferrando v. United States, 245 F.2d 582, 585 (9th Cir. 1957), *aff'g* 56-2 U.S. Tax Cas. 56,871 (1956) (bracketed material inserted by the court).

[36]56-2 U.S. Tax Cas. at 56,872. The court stated:

> Of course, laymen who act as executors cannot be expected to become experts in the field of estate administration. Some matters may be so far beyond their own knowledge, that they could not reasonably be charged with the duty even to make inquiry concerning them. *Haywood Lumber & Mining Co. v. Commissioner* . . . .
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> But, in these days when the filing of a variety of tax returns is a commonplace experience, it is not asking too much of an executor, who is aware that an estate tax must be paid, that he ascertain the time when the return and the tax are due. Ordinary prudence demands that he do so, for he must make sure that the necessary information and funds are available for a timely filing of the return and payment of the tax. Plaintiffs' neglect of this responsibility permitted their attorney to push aside the work of preparing and filing the estate tax return in favor of more pressing matters. Attentiveness on the part of plaintiffs would have prompted a timely filing.

[37]56-2 U.S. Tax Cas. 56,873 (N.D. Cal. 1956), *aff'd sub nom.* Ferrando v. United States, 245 F.2d 582 (9th Cir. 1957).

the administration of estates. Here, a needed appraisal had not been completed before the original due date of November 2, 1947. A tentative return that had been signed by the executors on October 31, 1947, was filed on the last day of a thirty-day extension.[38] The court held that the signing by an executor of a complete return represented by the preparer to be a proper return might constitute reasonable cause, but that the evidence presented in the instant case did not indicate that those conditions had been satisfied.[39]

Both of the above cases were appealed together.[40] The Ninth Circuit Court of Appeals noted that Ferrando's widow had an eighth-grade education and his son did not complete high school, but was able to run a concrete business. Ferrari's sons (the executors) ran a vegetable business. One son graduated from high school; the other did not. Nevertheless, the court held, "[O]ne does not have to be a professional co-executor or a probate lawyer to know that taxes have to be paid when they are due. . . . [T]his duty of vigilance and promptness is not a delegable one, so far as an executor is concerned. It is *personal*."[41] The judge stated that the filing of the tentative return in *Ferrari* was not sufficient because approval of so vague a return would "put a premium upon belated and slipshod filing."[42]

Apparently, the strong opinions rendered in the above cases were effective in prompting timely filing. The only Ninth Circuit estate tax case reported under current Internal Revenue Code provisions is *Pfeiffer v. United States.*[43] In *Pfeiffer*, the decedent died on March 17, 1962. Thus, the return was due on June 7, 1963. It was not filed until three months later. The executrix was the decedent's widow who had attended business college sixty years before his death, worked for an insurance company and lawyer from 1913 to 1918, and had performed minor secretarial chores for her husband. In administering the estate, she depended entirely on the attorney who had done the family's legal work for almost thirty years. She,

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[38]The court stated:

> The filing of such a tentative return as he described could not have constituted even substantial compliance with the statutory requirements for the filing of a return. Nor, could he have justifiedly relied on such a make-shift return as an adequate return, even if some deputy in the Collector's office had agreed to accept it and permit later alterations.

Id. at 56,874.

[39]*Id.*

[40]Ferrando v. United States, 245 F.2d 582 (9th Cir. 1957).

[41]*Id.* at 586 (emphasis in original).

[42]*Id.* at 588. The court cited Sanders v. Commissioner, 225 F.2d 629 (10th Cir. 1955), in which it was held that the filing of a skeletal income tax return did not constitute reasonable cause.

[43]315 F. Supp. 392 (E.D. Cal. 1970).

however, signed the Estate Tax Preliminary Notice (Form 704),[44] which was filed with the Internal Revenue Service. The court held that the executrix should have known that taxes had to be paid and that the return had a due date.[45] The court quoted *Ferrando* in determining that she had a personal, non-delegable duty to file a timely return.[46]

Based on *Ferrando, Ferrari,* and *Pfeiffer,* the prevailing legal reasoning in the Ninth Circuit is that if a return is known to be required, reliance on an attorney to file the return is not reasonable cause for delay. Inexperience or lack of education on the part of the executor is also not sufficient. The administrator must determine the due date of the return and has a personal, non-delegable duty to file the return by that date.

B. Second Circuit

The Second Circuit has been the arena for a great deal of litigation. As the cases below indicate, this circuit has developed the position that reliance on a professional is generally not sufficient to avoid penalties.

In the earliest case, *Powers v. United States,*[47] however, the court instructed the jury that reliance on an attorney could be reasonable cause. The judge said that the executor must have hired competent counsel, and requested him to prepare the proper returns.[48] During testimony, the taxpayer contended that he had relied on his lawyer, but the attorney stated that he gave no advice regarding the due date of the return. The executor also stated that he had had a mistaken belief concerning the due date of the estate tax return.[49] The court instructed the jury that a mistaken belief con-

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[44]An Estate Tax Preliminary Notice was required to be filed in cases where the gross estate exceeded $60,000 and the decedent died before January 1, 1971. Treas. Reg. § 20.6036-1(a)(1), T.D. 7238, 1973-1 C.B. 544. The form indicated that the estate tax return was due 15 months after the decedent's death.

[45]315 F. Supp. at 396. The court observed:

> [P]laintiff voluntarily assumed the position of executrix and received a commission for fulfilling the concomitant obligations. The position was not an honorary one. The mere acceptance of the job obligated the plaintiff to exercise at least a minimal amount of responsibility in superintending the administration of the estate. This is not to say that plaintiff was mistaken in hiring an experienced attorney and accountant to aid her, but rather that she was under an obligation to at least ascertain what her obligations were and to oversee the activities of Mr. Bybee [her attorney] and his accountant.

Id. at 396 (citing Estate of Duttenhofer v. Commissioner, 49 T.C. 200 (1967), *aff'd per curiam,* 410 F.2d 302 (6th Cir. 1969)).

[46]*Id.*

[47]63-2 U.S. Tax Cas. 90,426 (D. Conn. 1963).

[48]*Id.* at 90,427.

[49]Apparently the attorney did not prepare the return.

stituted reasonable cause if the executor had taken reasonable care to learn the correct rule.[50] The jury determined that the taxpayer had not shown adequate reason for the delay.

In *Estate of Lewis v. Commissioner*,[51] the decedent died on December 25, 1956. His estate tax return was due on March 25, 1958, but was not filed until October 7, 1958. The decedent's son and widow, the co-executors, hired the accountant who had performed the decedent's accounting for almost forty years. The co-executors had notice of the due date since the Estate Tax Preliminary Notice which they filed stated that the return was due fifteen months from the date of death. The accountant had recurring physical problems beginning in March 1956, including two heart attacks. As a result, he spent very little time in his office, where two assistants managed routine work but did not prepare estate tax returns. The co-executors inquired about the progress of the return and were advised that timely filing would depend on the accountant's health.

The court noted that the co-executors were on notice that the accountant might not have been able to file the return within the prescribed time[52] and observed that the co-executors probably knew the due date because of the preliminary notice. Judge Atkins held that the non-delegable duty of vigilance and promptness obligated them to ascertain the due date, if not known to them, and to file the return by that time.[53] Because the representatives knew a return had to be filed, they were not permitted to rely on cases holding that an attorney's advice that a return was not required constituted reasonable cause.[54]

In *Reed v. United States*,[55] the executor was the decedent's son, an attorney who had not practiced law since becoming president of Wilshire Oil Co. in 1955. The decedent died on June 29, 1959. The return was due on September 29, 1960, and was filed one month later. Since the executor was completely preoccupied with the company, he entrusted the entire administration of the estate to another lawyer.

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[50]63-2 U.S. Tax Cas. at 90,428.

[51]22 T.C.M. (CCH) 1732 (1963).

[52]On this basis, the court distinguished Fisk v. Commissioner, 203 F.2d 358 (6th Cir. 1953).

[53]22 T.C.M. (CCH) at 1737 (citing Ferrando v. United States, 56-2 U.S. Tax Cas. 56,871 (N.D. Cal. 1956), *aff'd*, 245 F.2d 582 (9th Cir. 1957).

[54]The taxpayers had relied on the decisions in Hatfried, Inc. v. Commissioner, 162 F.2d 628 (3d Cir. 1947) (holding an accountant's advice to a taxpayer that it was not a personal holding company was reasonable cause); Haywood Lumber & Mining Co. v. Commissioner, 178 F.2d 769 (2d Cir. 1950); Reliance Factoring Corp. v. Commissioner, 15 T.C. 604 (1950) (finding that employment of an accountant who decided that personal holding company returns were not required was adequate).

[55]64-2 U.S. Tax Cas. 94,431 (W.D.N.Y. 1964).

The return was filed after the due date because of confusion, lack of alternate values,[56] and the preparer's heavy schedule. The court determined that the delay was accidental and that revenue laws were not designed to penalize innocent errors. Therefore, it was held that the taxpayer had adequate reason for the late filing of the estate tax return.[57]

At this point, one district court had held that reliance on the specific advice of an attorney as to the due date of the return was reasonable cause. Another district court had stated that an executor could not depend on his lawyer to file the return if the executor knew an estate tax return was required. And yet another district court had provided that an executor could depend entirely on an attorney. In this setting, the Second Circuit Court of Appeals affirmed the Tax Court decision in *Estate of Mayer v. Commissioner.*[58]

In *Estate of Mayer*, the decedent died on October 9, 1958. The estate tax return was required to be filed by January 9, 1960, but was not actually filed until March 7, 1960. The executor, a certified public accountant with limited estate tax experience, hired an attorney who had previously filed eight estate tax returns. The accountant, however, filed the Estate Tax Preliminary Notice.

The executor and the attorney decided to have the New York tax authorities determine the value of certain closely held stock before filing the federal estate tax return. The accountant did not concern himself with the due date and the attorney miscalculated it. As a result, the return was late.

The accountant did not rely on the lawyer to value the stock. Therefore, according to the court, he had no reason to depend on the attorney to file the return.[59] *Estate of Mayer* did not involve a taxpayer who was unfamiliar with the tax laws and who merely supplied the preparer with necessary information without further participation.

Citing *Ferrando*, the court held that the executor must see that the attorney is diligent.[60] Since the accountant knew a return was required,[61] was active in the administration of the estate, had a tax

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[56]Alternate valuation is a means of valuing the assets of an estate on the date of disposal or six months after the date of death, whichever is earlier, if the change in value is due to economic change. I.R.C. § 2032. The election can only be made on a timely filed return. Treas. Reg. § 20.2032-1(b)(2) (1958).

[57]64-2 U.S. Tax Cas. at 94,432.

[58]43 T.C. 403 (1964), *aff'd per curiam*, 351 F.2d 617 (2d Cir. 1965), *cert. denied*, 383 U.S. 935 (1966).

[59]43 T.C. at 406.

[60]*Id.* (citing Ferrando v. United States, 56-2 U.S. Tax Cas. 56,871 (N.D. Cal. 1956), *aff'd*, 245 F.2d 582 (9th Cir. 1957).

[61]Thereby the instant case was distinguished from Haywood Lumber & Mining Co. v. Commissioner, 178 F.2d 769 (2d Cir. 1950).

background, and knew the due date,[62] it was determined that he did not have reasonable cause for the delinquent filing.

In *Estate of Lammerts v. Commissioner*,[63] the Tax Court imposed penalties because the executors were too passive. The estate tax return was timely filed, but the estate's income tax return was delinquent. The decedent's son, a co-executor, thought only an estate tax return was required. An accountant had prepared all of the family's personal and business income tax returns, but did not have access to the records needed to prepare the fiduciary return.

The taxpayer contended that, because he was inexperienced and ignorant that a return was required, he depended on the attorney who prepared the estate tax return and the accountant. The court held that ignorance of the filing requirement was not reasonable cause.[64] It observed that the executor has a positive duty to ascertain his responsibilities, and liability is not satisfied by the good faith belief that such obligations have been fulfilled.[65] The court further determined that the co-executors could not rely on the accountant because the situation was not discussed with him prior to the due date.[66] Further, they could not depend on the attorney because the matter was not "complicated [or] unusual, justifying such reliance."[67] Therefore, the late filing was held not due to reasonable cause.

The return in *Estate of Plotkin v. Commissioner*[68] was due on December 17, 1964, and a tentative return was filed on March 24, 1966. This return had been prepared by September 8, 1965, but was not signed by the executrix until the filing date.

The executrix, the widow of the decedent, was an attorney who had practiced little law before her husband's death. The lawyer she hired to advise her on estate tax said that it appeared no tax would be due, even though the estimated gross estate was $200,000. Therefore, the widow's attorney indicated that it would not matter if the return were filed late.[69] The court emphasized that the executrix was a

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[62]Therefore, the decision in Fisk v. Commissioner, 203 F.2d 358 (6th Cir. 1953), was held to be inapplicable.

[63]54 T.C. 420 (1970), *aff'd per curiam*, 456 F.2d 681 (2d Cir. 1972).

[64]*Id.* at 445. The decision in Haywood Lumber & Mining Co. v. Commissioner, 178 F.2d 769 (2d Cir. 1950), was distinguished on the ground that the executor had not supplied the accountant with the necessary information and requested him to prepare the proper returns.

[65]54 T.C. at 446. *See, e.g.*, Fides v. Commissioner, 137 F.2d 731 (4th Cir. 1943), *cert. denied*, 320 U.S. 797 (1943).

[66]54 T.C. at 447.

[67]*Id.* at 446 (quoting Bryan v. Commissioner, 32 T.C. 104 (1959), *aff'd*, 281 F.2d 238 (4th Cir. 1960), *cert. denied*, 364 U.S. 931 (1961)).

[68]31 T.C.M. (CCH) 1011 (1972).

[69]To this statement, the court replied: "The risk involved by following advice similar to [Attorney] Steinhoff's is that a taxable estate may emerge, displaying the foundation on which a penalty may be built." *Id.* 1013.

lawyer who knew the due date and found that her reliance on another attorney was not reasonable cause.

The widow also contended that the mental distress caused by the sudden death of her husband prevented her from filing the estate tax return on time. The court noted that illness could constitute a sufficient reason for late filing;[70] however, since the executrix continued to carry on normal activities, the court determined that illness did not amount to reasonable cause in this case.[71] Judge Sterrett also observed that the estate's involvement in extensive litigation should have put the executrix on notice that she needed assistance and an extension of time.[72] Finally, the court held that the executrix's argument that she was too busy was not reasonable cause.[73]

No estate tax return was ever filed by the executrix in *United States v. Lachman*.[74] She was the decedent's widow and essentially his sole devisee.[75] The gross estate was approximately $600,000. The taxpayer contended that her attorneys had neglected to file the return despite her requests that they do so. The court inferred that the personal representative had been uncooperative from evidence that she hired and fired four lawyers. Failure to file an estate tax return under such circumstances amounted to willful neglect, according to the court.[76]

The most recent decision in the Second Circuit was rendered in *Estate of DeVos v. Commissioner*.[77] There, the decedent died on January 3, 1968. The return was due on April 3, 1969, and was filed almost one year later. The administrator of the estate, a practicing attorney with no tax experience, hired another attorney. They both knew the due date of the estate tax return. On April 9, 1969, a request for extension of time was denied because no preliminary notice had been filed.

The administrator stated that he originally believed no return would be required. He later[78] decided that a return would have to be filed, but would result in no tax liability. The attorney for the estate indicated that he thought no return should be filed until a completely accurate one could be prepared. The court found that the ad-

[70]31 T.C.M. (CCH) at 1013 (citing Williams v. Commissioner, 16 T.C. 893 (1951)). In *Williams* the court ultimately decided that the taxpayer had not established that his illness was the cause of his failure to file income tax returns.

[71]31 T.C.M. (CCH) at 1013-14.

[72]The executrix had obtained an extension of time to file her 1964 income tax returns.

[73]31 T.C.M. (CCH) at 1014 (citing Dustin v. Commissioner, 53 T.C. 491 (1969)).

[74]73-1 U.S. Tax Cas. 81,210 (S.D.N.Y. 1973).

[75]The only exception was a specific bequest of $2,500. *Id.* at 81,212.

[76]73-1 U.S. Tax Cas. at 81,214.

[77]34 T.C.M. (CCH) 933 (1975).

[78]The administrator's decision was made in November, 1968. *Id.* at 936.

ministrator could have determined the assets of the estate with sufficient accuracy to have filed the return by the due date or shortly after the extension was denied.[79]

The court held that an executor, particularly if he is an attorney,[80] "cannot avoid his obligation to file a timely return by delegating to another the responsibility for preparing and filing his return."[81] The court noted that the administrator did not receive definite advice that the return could be filed late without incurring any penalties.[82] *Haywood* was distinguished because the administrator had not supplied all necessary information to the attorney and had not requested that the return be prepared.[83] The decision in *Fisk v. Commissioner*[84] was distinguished on the length of the delay in filing.[85]

As a result of the case law in the Second Circuit, an executor must ascertain his responsibilities and the due date of the return. He may not delegate his duty to file a timely estate tax return to the attorney.[86] In addition, the mistaken belief of an executor is reasonable cause only if he took reasonable care to learn the correct rule. Illness of the preparer is not adequate reason if the personal representative is aware of the disability. If the executor continues his normal activities, his physical condition will not excuse delinquency. Simple ignorance of a filing requirement or a belief that no tax is due is not sufficient.[87] And finally, difficulty in determining the assets of the estate is not reasonable cause for late filing.

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[79] 34 T.C.M. (CCH) at 940.

[80] *Id.* at 941 (citing Estate of Mayer v. Commissioner, 43 T.C. 403 (1964), *aff'd per curiam,* 351 F.2d 617, *cert. denied,* 383 U.S. 935 (1966).

[81] 34 T.C.M. (CCH) at 941 (citing Maudlin v. Commissioner, 60 T.C. 749 (1973)). In *Maudlin,* it was found that reliance on an accountant to file an income tax return was not reasonable cause.

[82] The holding in Bryan v. Commissioner, 32 T.C. 104 (1959), *aff'd,* 281 F.2d 238 (4th Cir. 1960), *cert. denied,* 364 U.S. 931 (1961), was distinguished because declarations of estimated tax were not filed timely due to the accountant's indication that one declaration would satisfy the requirement.

[83] 34 T.C.M. (CCH) at 941.

[84] 203 F.2d 358 (6th Cir. 1953). The court determined that, if the delay was only one day, reliance on an attorney was reasonable cause.

[85] 34 T.C.M. (CCH) at 941.

[86] In Estate of Lewis v. Commissioner, 22 T.C.M. (CCH) 1732 (1963), the court distinguished Haywood Lumber & Mining Co. v. Commissioner, 178 F.2d 769 (2d Cir. 1950), on the ground that it held that a taxpayer could rely on legal advice only if it related to whether a return was due. All other cases referring to *Haywood* distinguished the decision on the basis of the facts presented, rather than on the legal principles involved.

[87] *Contra,* Estate of Christ v. Commissioner, 54 T.C. 493 (1970), *aff'd on other grounds,* 480 F.2d 171 (6th Cir. 1973).

C. Tenth Circuit

There is little relevant case law available in the Tenth Circuit. The court of appeals has not ruled on the issue of reasonable cause in an estate tax context. Nevertheless, since this discussion is intended to be comprehensive, the single reported opinion is included.

In *Estate of Klein v. Commissioner*,[88] the decedent died intestate on October 22, 1968, leaving no heirs who were residents of his domicile. The lawyer who was retained recommended that an employee of his firm be administrator and the employee was appointed.[89] Although the personal representative knew an estate tax return was due, he failed to file one. After the attorney discovered that the return had not been filed, he prepared and submitted it as soon as was possible, nearly four months late.

The court noted, "A good faith reliance on professional advice may sometime excuse a failure to file [in a] timely [manner]."[90] The excuse is only applicable, however, when a taxpayer who is unfamiliar with tax law receives advice that no return need be filed.[91] Since those conditions were not met, there was no reasonable cause for the late filing. The court stated that it had no jurisdiction to waive the penalties on the ground that the heirs were blameless.[92] Thus, the current law in the Tenth Circuit can be ascertained only in terms of a 1975 Tax Court memorandum decision holding that a personal representative may avoid penalties only by relying on professional advice that no return need be filed.

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[88]34 T.C.M. (CCH) 567 (1975).

[89]The employee was a former attorney who had been suspended from the bar.

[90]34 T.C.M. (CCH) at 569 (citing Paula Constr. Co. v. Commissioner, 58 T.C. 1055 (1972); West Coast Ice Co. v. Commissioner, 49 T.C. 345 (1968); Estate of Collino v. Commissioner, 25 T.C. 1026 (1956); Burruss Land & Lumber Co. v. United States, 349 F. Supp. 188 (W.D. Va. 1972)).

In *Paula Construction Co.*, the court held that reliance on counsel was reasonable cause if the professional advice related to a complex question. The dependence on an accountant to file a Subchapter S corporate income tax return which the taxpayer knew was due was not adequate.

No penalties were imposed in *West Coast Ice Co.* The accountant did not prepare personal holding company returns because he thought the taxpayer did not meet that status.

An attorney's advice that the gross estate was less than the statutory exemption and that, therefore, no return was required, was found to constitute reasonable cause for the late filing of an estate tax return in *Estate of Collino.*

In *Burruss Land & Lumber Co.*, the court determined that reliance on house counsel that no excise tax return was required was sufficient cause.

[91]Estate of Lammerts v. Commissioner, 54 T.C. 420 (1970), *aff'd per curiam*, 456 F.2d 681 (2d Cir. 1972); Estate of Duttenhofer v. Commissioner, 49 T.C. 200 (1967), *aff'd per curiam*, 410 F.2d 302 (6th Cir. 1969).

[92]"The heirs remedy lies in another forum." 34 T.C.M. (CCH) at 570.

D. Sixth Circuit

The Sixth Circuit has essentially developed in the same manner as the Second Circuit and has concluded that reliance on counsel is not reasonable cause. Like *Ferrando v. United States*,[93] *Fisk v. Commissioner*,[94] is based on the Internal Revenue Code of 1939. *Fisk* is discussed because, although the holding is very narrow, it is often cited.[95] In *Fisk* the return was due on July 21, 1947, was mailed on that date, and was received on July 22, 1947. At that time, the return had to be received within the period for filing.[96]

The court of appeals found that reliance on counsel for the preparation and filing of returns permitted the avoidance of delinquency penalties.[97] It refused to impute the acts of the attorney to the taxpayer stating that to do so would hold the executrix to a higher standard of care than that generally required of laymen.[98] Therefore, the court determined that reliance upon an attorney as reasonable cause applied "to the filing of tax returns as well as to reliance upon technical advice in complicated legal matters."[99] Judge Allen stated that the ruling was in accordance with the principle

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[93] 56-2 U.S. Tax Cas. 56,871 (N.D. Cal. 1956), *aff'd*, 245 F.2d 582 (9th Cir. 1957).

[94] 203 F.2d 358 (6th Cir. 1953).

[95] *Fisk* has been distinguished in Estate of Duttenhofer v. Commissioner, 49 T.C. 200 (1967), *aff'd per curiam*, 410 F.2d 302 (6th Cir. 1969); Estate of Mayer v. Commissioner, 43 T.C. 403 (1964), *aff'd per curiam*, 351 F.2d 617 (2d Cir. 1965), *cert. denied*, 383 U.S. 935 (1966); Estate of DeVos v. Commissioner, 34 T.C.M. (CCH) 933 (1975); Estate of Geraci v. Commissioner, 32 T.C.M. (CCH) 424 (1973), *aff'd per curiam*, 502 F.2d 1148 (6th Cir. 1974), *cert. denied*, 420 U.S. 992 (1975); Estate of Rose v. Commissioner, 32 T.C.M. (CCH) 461 (1973); Estate of Lewis v. Commissioner, 22 T.C.M. (CCH) 1732 (1963).

[96] Timely mailed is now timely filed. I.R.C. § 7502.

[97] *Cf.* Dayton Bronze Bearing Co. v. Gilligan, 281 F. 709 (6th Cir.), *cert. denied sub nom.* Dayton Brass Castings Co. v. Gilligan, 258 U.S. 619 (1922) (attorney advised the company it was not subject to munitions tax); Haywood Lumber & Mining Co. v. Commissioner, 178 F.2d 769 (2d Cir. 1950); Orient Inv. & Fin. Co. v. Commissioner, 166 F.2d 601 (D.C. Cir. 1948) (the accountant decided that the taxpayer was not a personal holding company); C.F. Lindback Foundt'n v. Commissioner, 4 T.C. 652 (1945) (lawyer informed the foundation that it was not required to file income tax returns because it was an exempt organization); Brooklyn & Richmond Ferry Co. v. Commissioner, 9 T.C. 865 (1947), *aff'd*, 171 F.2d 616 (2d Cir. 1948), *cert. denied*, 336 U.S. 968 (1949) (accountant advised the taxpayer that it was not required to file an excess profits tax return); Safety Tube Corp. v. Commissioner, 8 T.C. 757 (1947), *aff'd*, 168 F.2d 787 (6th Cir. 1948) (attorney indicated to the business that it was not a personal holding company); Houk v. Commissioner, 6 T.C.M. (CCH) 761 (1947) (attorney told the taxpayer that income from a trust was not taxable).

[98] Fisk v. Commissioner, 203 F.2d at 359 (citing Haywood Lumber & Mining Co. v. Commissioner, 178 F.2d 769 (2d Cir. 1950)).

[99] 203 F.2d at 360.

that penalties were to be imposed upon conduct which was voluntary, rather than accidental or resulting from innocent errors.[100]

In *Estate of Duttenhofer v. Commissioner*,[101] the decedent died on February 22, 1963. The estate tax return was due on May 22, 1964, and was filed on October 27, 1964. One of the co-executors was the brother of the decedent, who was seventy-seven, had four years of formal education, and was a factory employee. The other co-executor was the president of a corporation, a high school graduate, and thirty-eight years old.

They hired an attorney, who had twenty years experience, with whom they had had only minimal contact before the decedent's death. An Estate Tax Preliminary Notice was filed. The attorney controlled the administration of the estate. On September 16, 1964, he requested an extension of time in which to file the estate tax return, but the request was denied.[102]

The court found that the co-executors made no effort to determine their duties and completely abdicated their responsibilities to the attorney. It stated that a personal representative who knows a return is required must determine the due date and see to it that the attorney is diligent.[103] The co-executors contended that reliance on an attorney to prepare and file a return was reasonable cause, citing several cases.[104] The court stated:

> We think reliance upon these cases is misplaced. In the situations involved in those cases the taxpayers, *without knowledge* that certain tax returns were required, were found to have reasonably relied upon their tax advisers to determine whether a return should be filed and if so to prepare the necessary returns for filing.[105]

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[100]*Id.* (citing Spies v. United States, 317 U.S. 492 (1943); United States v. Murdock, 290 U.S. 389 (1933)). Both *Murdock* and *Spies* related to the imposition of criminal sanctions for willful evasion of income tax.

[101]49 T.C. 200 (1967), *aff'd per curiam*, 410 F.2d 302 (6th Cir. 1969).

[102]The extension was denied because it had not been requested before the due date of the return and it was not signed by the taxpayer or his authorized representative. 49 T.C. at 203.

[103]*Id.* at 205 (citing Ferrando v. United States, 56-2 U.S. Tax Cas. 56,871 (N.D. Cal. 1956), *aff'd*, 245 F.2d 582 (9th Cir. 1957)).

[104]The taxpayers cited Orient Inv. & Fin. Co. v. Commissioner, 166 F.2d 601 (D.C. Cir. 1948) (*see* note 97 *supra*); Haywood Lumber & Mining Co. v. Commissioner, 178 F.2d 769 (2d Cir. 1950) (*see* notes 23-27 *supra* and accompanying text); Brooklyn & Richmond Ferry Co. v. Commissioner, 9 T.C. 865 (1947), *aff'd*, 171 F.2d 616 (2d Cir. 1948), *cert. denied*, 336 U.S. 968 (1949) (*see* note 97 *supra*); Hatfried, Inc. v. Commissioner, 162 F.2d 628 (3d Cir. 1947) (accountant advised the taxpayer that it was not a personal holding company); Safety Tube Corp. v. Commissioner, 8 T.C. 757 (1947), *aff'd*, 168 F.2d 787 (6th Cir. 1948) (*see* note 97 *supra*).

[105]49 T.C. at 205 (emphasis in original).

The court distinguished *Fisk* on the ground that the facts in *Fisk* did not show that the executrix failed to act prudently or that she knew a return was required.[106]

The taxpayer also contended that litigation prevented timely filing. It was noted that the co-executors could have requested an extension in the proper fashion or could have filed a timely return based on the information then available.

In affirming the trial court, the court of appeals stated that *Fisk* was not a comparable case because of the lengths of delay in the two cases.[107] Thus, the court did not reverse *Fisk*, but did limit its scope to situations involving a very minimal delay.[108]

The decision in *Estate of Rose v. Commissioner*[109] followed *Estate of Duttenhofer*. In *Estate of Rose*, the decedent died on March 4, 1967. The return was due on June 4, 1968, and was filed more than five months later. The executor (the decedent's son) hired an attorney with forty-five years of experience, but who did not consider himself a tax expert. The taxpayer did not request that a return be filed or request to know the due date of the return.

The court stated that the executor has a positive duty to ascertain his responsibilities; simple passivity does not constitute reasonable cause.[110] The court distinguished *Fisk* on the basis of the length of the delay, and the other cases relied upon by the executor[111] on the ground that those opinions related to advice from an attorney that no return was required.[112]

In *Estate of Geraci v. Commissioner*,[113] the decedent died on March 27, 1967. The estate tax return was due on June 27, 1968, and was filed on August 28, 1968, two months and one day late. The executrix, the decedent's widow, hired an attorney, who was ill for several weeks during late May or early June, 1968. The executrix contended that there was reasonable cause for the delay in that she had relied on the attorney to file the return. The attorney mistakenly thought the return was due fifteen months from the appointment

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[106] *Id.* at 206.

[107] The delinquency in *Fisk* was one day. In *Estate of Duttenhofer*, it was over five months.

[108] 410 F.2d 302.

[109] 32 T.C.M. (CCH) 461 (1973).

[110] *Id.* at 464 (citing Estate of Lammerts, v. Commissioner, 54 T.C. 420 (1970), *aff'd in part per curiam*, 456 F.2d 681 (2d Cir. 1972)).

[111] McColgan v. Commissioner, 10 B.T.A. 958 (1928); Estate of Collino v. Commissioner, 25 T.C. 1026 (1956); Estate of Christ v. Commissioner, 54 T.C. 493 (1970), *aff'd on other grounds*, 480 F.2d 171 (9th Cir. 1973). In those cases an attorney advised the taxpayer that an estate tax return was not required.

[112] 32 T.C.M. (CCH) at 464.

[113] 32 T.C.M. (CCH) 424 (1973), *aff'd per curiam*, 502 F.2d 1148 (6th Cir. 1974), *cert. denied*, 420 U.S. 992 (1975).

of the executrix, which would have made the due date August 1, 1968.

The court stated that the key to its decision was the passive role of the executrix.[114] It held that reliance on the attorney was not reasonable cause and that, therefore, reliance on his mistake as to the due date was not adequate.[115] The personal representative was required to ascertain the due date and to file timely.[116] The attorney's illness was not a sufficient excuse for late filing because there was no evidence that the executrix was unaware of the disability. Further, it appeared that other members of the attorney's firm could have filed the return.[117]

The court of appeals affirmed the decision of the Tax Court, but indicated that it was unenthusiastic about the determination. The appellate opinion stated that the attorney had orally requested an extension, and an Internal Revenue employee had told him that the statute was seldom enforced if the return was filed within a reasonable time and if there was some reason for the delay.[118] Further, the court of appeals disagreed with the lower court's characterization of the executrix as passive, suggesting that she was as active as could reasonably be expected.[119]

In *Estate of Bradley v. Commissioner*,[120] the scope of the other decisions in the Sixth Circuit was somewhat narrowed. There, the decedent's son-in-law, a practicing attorney with no tax work, was one of the co-executors. He asked an accountant, employed by an accounting firm upon which he had previously relied, the due date of the estate tax return. The accountant thought the attorney wanted to know the due date for the state inheritance tax return and indicated that it was eighteen months after the decedent's death.

The decedent had died on January 30, 1969. Thus, the estate tax return was actually due on April 30, 1970. It was prepared by the

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[114]32 T.C.M. (CCH) at 426 (citing Estate of Lammerts v. Commissioner, 54 T.C. 420 (1970), *aff'd in part per curiam*, 456 F.2d 681 (2d Cir. 1972)).

[115]32 T.C.M. (CCH) at 426.

[116]32 T.C.M. (CCH) at 425-26 (citing Ferrando v. United States, 56-2 U.S. Tax. Cas. 56,871 (N.D. Cal. 1956), *aff'd*, 245 F.2d 582 (9th Cir. 1957); Pfeiffer v. United States, 315 F. Supp. 392 (E.D. Cal. 1970); Estate of Duttenhofer v. Commissioner, 49 T.C. 200 (1967), *aff'd per curiam*, 410 F.2d 302 (6th Cir. 1969)).

[117]Robinson's Dairy, Inc. v. Commissioner, 302 F.2d 42 (10th Cir. 1962). Illness of the taxpayer's accountant was not reasonable cause because the taxpayer was aware of it.

[118]There was no written request for an extension and the conversation was unverified. Therefore, the Tax Court must have chosen not to believe the attorney's testimony on the matter.

[119]It was stipulated that the executrix relied entirely on the attorney to file the return. 32 T.C.M. (CCH) at 425.

[120]33 T.C.M. (CCH) 70 (1974), *aff'd*, 511 F.2d 527 (6th Cir. 1975).

accountant and given to the co-executor on May 28, 1970. The return was received by the Internal Revenue Service on June 1, 1970.

The government contended that the co-executor had a personal, non-delegable duty to file the return timely. It further contended that the co-executor was charged with knowledge of the due date by virtue of his profession as an attorney. The court refused to impute knowledge of the due date to the personal representative because his practice did not include tax work.[121] The court stated:

> To sustain respondent's argument would require a holding that an executor may rely upon the advice of an expert on substantive tax law questions but, as a matter of law, may not do so with respect to the requirements of the law as to the due date of tax returns—that he must research that question for himself. We decline to so hold. We fail to see a significant distinction between the reasonableness of a failure to file at all and the reasonableness of a failure to file on time, where in both circumstances the taxpayer has relied on the advice of competent counsel.[122]

Apparently, the Sixth Circuit will consider the advice of a professional to be adequate reason for delay if the professional is specifically requested to state the estate tax return due date and misinforms the taxpayer. Otherwise, an attorney's mistake regarding the due date is not sufficient cause. The executor cannot be passive and be successful in asserting reasonable cause as a defense to the imposition of penalties. The administrator must at least make sure that the attorney for the estate is diligent. Illness of the preparer is no excuse if the executor is aware of the disability or if other firm members could file the return.

E. Seventh Circuit

Analysis of the Seventh Circuit demonstrates that the courts are becoming ever more narrow in defining reasonable cause. The earliest pertinent case, *Giesen v. United States*,[123] however, used the broader concept enunciated in *Haywood Lumber & Mining Co. v. Commissioner*.[124] In *Giesen*, the decedent died on August 30, 1964. The estate tax return was due November 30, 1965, and was filed June 18, 1968, accompanied by the executor's check dated February 10, 1968.

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[121] *Id.* at 72. *Compare* Estate of Mayer v. Commissioner, 43 T.C. 403 (1964), *aff'd per curiam*, 351 F.2d 617 (2d Cir. 1965) *cert. denied*, 383 U.S. 935 (1966).

[122] 33 T.C.M. (CCH) at 73.

[123] 369 F. Supp. 33 (W.D. Wis. 1973).

[124] 178 F.2d 769 (2d Cir. 1950), *rev'g* 12 T.C. 735 (1949).

The personal representative, the decedent's son, was a doctor with no knowledge of business practices. He hired the attorney who had represented the estate of the executor's father. The lawyer, with thirty-four years of experience, was reputed to be an expert in probate law and taxation. The counselor controlled the administration of the estate. The executor had inquired about the progress of the estate, and the attorney had assured him that the matter was being handled in accordance with the law.

The court stated that it was adopting the majority view in holding that an administrator may establish reasonable cause by relying on a professional if certain conditions are met.[125] The taxpayer must be unfamiliar with tax law and make full disclosure to the attorney. He also has to exercise ordinary business care and prudence by selecting an expert, supplying him with the relevant information, and requesting him to prepare the necessary returns.[126] The court said that this rule had been adopted in many cases.[127] It further held that the position had been adopted by the Seventh Circuit.[128]

In *Estate of Crute v. Commissioner*,[129] the decedent's will was admitted to probate in Indiana, and a bank president was appointed executor.[130] Later, Connecticut authorities asserted that the decedent

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[125]369 F. Supp. at 35.

[126]*Id.* at 36. The court stated that the holding in Ferrando v. United States, 56-2 U.S. Tax Cas. 56,871 (N.D. Cal. 1956), *aff'd*, 245 F.2d 582 (9th Cir. 1957), represented the minority position followed only by the Ninth Circuit.

[127]*Id.* (citing Educational Fund of Electrical Indus. v. United States, 424 F.2d 1053 (2d Cir. 1970) (reliance on an attorney's advice that the taxpayer was not subject to withholding tax was not sufficient because the organization had received a contrary ruling of the Internal Revenue Service); Rubber Research, Inc. v. Commissioner, 422 F.2d 1402 (8th Cir. 1970) (taxpayer did not establish it received expert advice regarding whether any tax was due); Estate of Mayer v. Commissioner, 43 T.C. 403 (1964), *aff'd per curiam*, 351 F.2d 617 (2d Cir. 1965), *cert. denied*, 383 U.S. 935 (1966) (*see* note 58 *supra* and accompanying text); Fisk v. Commissioner, 203 F.2d 358 (6th Cir. 1963); Mayflower Inv. Co. v. Commissioner, 239 F.2d 624 (5th Cir. 1956) (advice of corporate officer inadequate because the taxpayer had not taken care to learn the correct rule); Burton Swartz Land Corp. v. Commissioner, 198 F.2d 558 (5th Cir. 1952) (accountant advised the taxpayer that it was not a personal holding company); Haywood Lumber & Mining Co. v. Commissioner, 178 F.2d 769 (2d Cir. 1950) (*see* note 23 *supra* and accompanying text); Davis v. Commissioner, 184 F.2d 86 (10th Cir. 1950) (fraud penalty was not imposed because the taxpayer had furnished all information to a certified public accountant and requested that he prepare the return); Hatfried Inc. v. Commissioner, 162 F.2d 628 (3d Cir. 1947) (*see* note 104 *supra*); Orient Inv. & Fin. Co. v. Commissioner, 166 F.2d 601 (D.C. Cir. 1948) (*see* note 97 *supra*); Burruss Land & Lumber Co. v. United States, 349 F. Supp. 188 (W.D. Va. 1972) (*see* note 90 *supra*); Dexter v. United States, 306 F. Supp. 415 (N.D. Miss. 1969)).

[128]*Id.* (citing Commissioner v. American Ass'n of Eng'rs Employment, 204. F.2d 19 (7th Cir. 1953)).

[129]33 T.C.M. (CCH) 1073 (1974).

[130]He had previously served as an executor in his own individual capacity and as president of the bank.

might have been a domiciliary of that state. The accountant, hired by the personal representative, advised the executor that he did not have standing to file an estate tax return until the issue of the decedent's domicile was resolved. Although he relied on the accountant's advice, the representative was active in the administration of the estate.

The court found that because the bank president was aware of his responsibilities[131] and because he was active in the administration of the estate,[132] he had exercised ordinary business care and prudence in relying upon the accountant's advice.[133]

In *Fisher v. United States*,[134] the executrix was a housewife who hired her husband, an attorney, to represent the estate. The court held that the executrix had met the conditions set forth in *Giesen* and determined that she had adequate reason for the late filing of the return. The judge stated that Congress should impose delinquency penalties only on the person actually responsible for the delay.[135] He noted that in this case, as in many others, the attorney did not have sufficient reason for failing to file the return within the prescribed time.

In *Clum v. United States*,[136] the executor was the decedent's brother, a sixty-year-old farmer with a high school education. He depended entirely on the attorney who had written the decedent's will to manage the affairs of the estate. The court found that the executor met the requirements listed in *Giesen* and held that his reliance excused the late filing.[137]

The Seventh Circuit trend begun with *Giesen* was halted with the decision in *United States v. Kroll*,[138] the first estate tax delinquency penalty case to be heard by the Seventh Circuit Court of Appeals. In *Kroll*, the decedent died on July 13, 1967. The estate tax return was due on October 13, 1968, and was filed one year later. The executor, the husband of the sole heir, was a college graduate with one year of law school and had worked for a large industrial company and a brokerage firm. He hired an attorney to prepare the estate tax return. On January 1, 1969, the Internal Revenue Service notified the personal representative that no return had been filed.

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[131]*But see* Estate of Lammerts v. Commissioner, 54 T.C. 420 (1970), *aff'd in part per curiam*, 456 F.2d 681 (2d Cir. 1972).

[132]*Compare* Estate of Duttenhofer v. Commissioner, 49 T.C. 200 (1967), *aff'd per curiam*, 410 F.2d 302 (6th Cir. 1969).

[133]33 T.C.M. (CCH) at 1075.

[134]75-2 U.S. Tax Cas. 88,819 (W.D. Wis. 1975).

[135]*Id.* at 88,820.

[136]76-2 U.S. Tax Cas. 85,685 (S.D. Ohio 1976).

[137]*Id.* at 85,686 (citing Fisk v. Commissioner, 203 F.2d 358 (6th Cir. 1953)).

[138]547 F.2d 393 (7th Cir. 1977).

In a decision written by Leonard P. Moore, Senior Judge for the Second Circuit, sitting by designation, the court held that a taxpayer has reasonable cause for late filing if he depends on an attorney to determine whether a return is required.[139] Since the executor in *Kroll* knew a return was required, it was immaterial that he was not experienced and had made full disclosure to the lawyer. The court found that a person with minimal business experience knows returns have deadlines and that he must sign and return before it is filed.[140] In this case, the executor has notice of the exact due date. Judge Moore held that when there is no question that a return is required, the taxpayer has a personal, non-delegable duty to file the return when it is due.[141]

The holding in *Kroll* was extended in *Ruel v. United States.*[142] In *Ruel*, the executor contended that the taxpayer in *Kroll* was more educated and had received notice from the Internal Revenue Service that the estate tax return was due. In response the district court stated, "The factual distinctions urged by the plaintiffs do not exempt them from the impact of the broad language of *Kroll*."[143]

Thus, the current position in the Seventh Circuit is that when an executor knows a return is required, he has a personal, non-delegable duty to file in a timely manner. If an executor is active and aware of his duties, he may rely on professional advice that he has no need to file an estate tax return.

F. Eighth Circuit

In *Northwestern National Bank v. United States*,[144] the decedent died on August 28, 1966, and the return was due on November 28, 1967. It was not filed until May 11, 1970. The decedent's will was

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[139]*Id.* at 396 (citing Commissioner v. American Ass'n of Eng'rs Employment, 204 F.2d 19 (7th Cir. 1953); Burton Swartz Land Corp. v. Commissioner, 198 F.2d 558 (5th Cir. 1952); Orient Inv. & Fin. Co. v. Commissioner, 166 F.2d 601 (1946); Hatfried, Inc. v. Commissioner, 162 F.2d 628 (3d Cir. 1947).

[140]547 F.2d at 396.

[141]*Id. See* Commissioner v. American Ass'n of Eng'rs Employment, 204 F.2d 19 (7th Cir. 1953); Cedarburg Canning Co. v. Commissioner, 149 F.2d 526 (7th Cir. 1945) (taxpayer's belief that it was not a personal holding company was not sufficient); *cf.* Rubber Research, Inc. v. Commissioner, 422 F.2d 1402 (8th Cir. 1970) (*see* note 145 *infra*); Estate of Duttenhofer v. Commissioner, 49 T.C. 200 (1967), *aff'd per curiam*, 410 F.2d 302 (6th Cir. 1969) (*see* note 101 *supra* and accompanying text); Coates v. Commissioner, 234 F.2d 459 (8th Cir. 1956) (taxpayer did not request specific advice regarding estimated tax and penalties were imposed). *But see* Consolidated-Hammer Dry Plate & Film Co. v. Commissioner, 317 F.2d 829 (7th Cir. 1963) (a taxpayer's beliefs that an extension had been obtained was not reasonable cause).

[142]77-1 U.S. Tax Cas. 87,260 (E.D. Wis. 1977).

[143]*Id.*

[144]72-2 U.S. Tax Cas. 86,006 (D. S. Dak. 1972).

held to be invalid, and a bank was appointed special administrator on January 29, 1968. The state supreme court reversed the trial court's decision concerning the appointment on March 24, 1970, and the same financial institution then became the executor of the estate.

The bank did not file the return earlier for two reasons: (1) It was uncertain of its status and the costs of litigation, and (2) its attorney advised it not to file until the final determination. The lawyer testified that an accurate return could not be made until the supreme court decision. Reliance on counsel was the exercise of ordinary business care and prudence according to the district court.[145] Therefore, the court held that the executor had reasonable cause for the late filing of the return.

In *Jacobson v. United States*[146] the jury rendered a verdict in favor of the administratrix.[147] Only the instructions and the verdict were reported. The court indicated that the jury could consider whether the administratrix had relied upon her attorney, but did not state the legal effect of such reliance.

In *Richter v. United States*[148] the decedent died on May 23, 1971, and the return was due nine months later. Although the administrator of the estate, the decedent's son, filed Form 704 which stated that the return was due fifteen months from the date of death,[149] the return was not filed until January 22, 1974.

The administrator hired the law firm that had represented him when he was administrator of his uncle's estate. Despite the taxpayer's lack of business and tax law experience, his filing of Form 704 and his increasingly frequent trips to the attorney's office to inquire about the progress of the estate indicated his awareness of the necessity to file the return. At no time did he ask the due date of the return or was he advised that no return need be filed.

Because the attorney did not tell the administrator to delay filing, the court distinguished *Northwestern National Bank*.[150] Relying on *Kroll*, *Ferrando* and *Pfeiffer*,[151] the court held that the represen-

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[145] 72-2 U.S. Tax Cas. at 86,007 (citing Rubber Research v. Commissioner, 442 F.2d 1402 (8th Cir. 1970)). *Rubber Research* held that the taxpayer's belief that no tax was due was not reasonable cause since the taxpayers did not establish that it relied on legal advice to that effect. The court in *Northwestern Nat'l Bank* inferred from *Rubber Research* that, if a taxpayer relied on an attorney, he would have reasonable cause.

[146] 3 Fed. Est. & Gift Tax Rep. (CCH) (78-1 U.S. Tax Cas.) ¶ 13,231 (D.N.D. Sept. 24, 1977).

[147] *Id.*

[148] 77-2 U.S. Tax Cas. 88,649 (D. Minn. Oct. 3, 1977).

[149] The return was actually due nine months after the date of death. *See* note 1 *supra*.

[150] 77-2 U.S. Tax Cas. at 88,650.

[151] *Id.* at 88,651.

tatives of the estate had not established reasonable cause for the late filing of the return. Apparently, the Eighth Circuit has limited *Northwestern National Bank* to its facts and will follow the majority position when applicable.

G. *Third Circuit*

In *Estate of Campbell v. United States*[152] the co-executors contended that their reliance on an attorney to file the estate tax return was reasonable cause. The co-executors were unfamiliar with estate tax laws, but the operation of a printing business by one was sufficient experience for the court to infer that he knew that tax returns had due dates. The taxpayers introduced no evidence as to whether they asked about the due date or were given advice about the same. The court held that *Kroll* controlled and that the penalties were properly imposed.[153]

H. *Summary*

A comparison of the holdings of the various circuits[154] indicates that the majority have determined that the executor has a personal, non-delegable duty to ascertain his responsibilities and to see that they are fulfilled in timely fashion. The personal representative cannot be passive and his inexperience or lack of education are irrelevant. Ignorance of the requirement to file a return, a belief that no tax is due, and difficulty in determining the assets of an estate are not defenses to the imposition of penalties. An executor, however, may rely on professional advice regarding the due date or his standing to file a return if the advice is specifically requested.

Illness of the preparer is not adequate reason for delay if the executor is aware of the infirmity or there are other members of the firm able to file the return. The personal representative's physical condition is not reasonable cause of he continues his normal activities.

III. Other Assertions of Reasonable Cause

As noted in *Klein*,[155] the fact that the beneficiaries are not at fault is no defense. This issue was also raised in *Estate of Hollenbeck v. United States*[156] and in *United States v. Mize*.[157]

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[152]77-2 U.S. Tax Cas. 88,665 (D.N.J. Oct. 12, 1977).

[153]*Id.* at 88,669.

[154]The absence of litigation in other circuits may mean that the Internal Revenue Service or the taxpayers have not chosen to litigate the issue or that estate tax returns are timely filed in those jurisdictions.

[155]34 T.C.M. (CCH) 567 (1975).

[156]77-2 U.S. Tax Cas. 86,109 (D. Col. 1972).

[157]73-1 U.S. Tax Cas. 81,303 (C.D. Cal. 1972).

In *Estate of Hollenbeck*, the decedent died on October 29, 1965. The estate tax return was due on January 29, 1967, and was filed on October 30, 1968. The attorney, who was named executor in the decedent's will, had substantial probate experience and was familar with inheritance tax, but had never filed an estate tax return. He had access to all necessary information. The court stated that since the estate, not the beneficiaries, was the taxpayer, the inexcusable neglect of the executor caused imposition of penalties.[158]

The concept of blamelessness is present in *Mize*, although no reason for late filing was stated in the facts. The decedent died on April 11, 1953, and the return was due on July 11, 1954. It was not filed until April 28, 1965. The administrator was not appointed until 1971. The decedent's daughter (who was not the personal representative) filed the return. The facts of the case do not indicate who was responsible for filing as of the due date. The administrator, even though he was not serving when the return was due, was held liable for the penalties.[159]

In *Estate of Pridmore v. Commissioner*,[160] the executor contended that litigation involving the estate required a delay in filing. The court noted that the taxpayer was an attorney who was familiar with the requirements of estate tax returns. The court held that since he could have obtained an extension and did not request one there was no reasonable cause for failing to file the return on time.[161] The decisions in *Estate of Duttenhofer v. Commissioner*[162] and *Estate of Plotkin v. Commissioner*[163] also held that a lawsuit affecting the taxability of the estate was not sufficient reason for delinquency. The court in *Northwestern National Bank v. United States*[164] held that litigation could excuse late filing. That suit, however, concerned the legal status of the executor.

In *Estate of Moesch v. Commissioner*,[165] the court held that lack of funds needed to pay the tax did not constitute reasonable cause. The decedent died on January 4, 1966, and the administrator was appointed on February 2, 1966. The return was due April 4, 1967, and was filed January 7, 1970. During the course of certain discovery proceedings on May 13, 1966, the administrator found that the decedent had transferred $20,000 to her attorney during her lifetime, but within three years of her death. The only reason for not filing given

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[158] 77-2 U.S. Tax Cas. at 86,109.
[159] 73-1 U.S. Tax Cas. at 81,304.
[160] 20 T.C.M. (CCH) 47 (1961).
[161] *Id.* at 55.
[162] 49 T.C. 200 (1967), *aff'd per curiam*, 410 F.2d 302 (6th Cir. 1969).
[163] 31 T.C.M. (CCH) 1011 (1972).
[164] 72-2 U.S. Tax Cas. 86,006 (D.S. Dak. 1972).
[165] 33 T.C.M. (CCH) 1271 (1974).

by the executor was his lack of funds.[166] The court found the administrator liable.

IV. Conclusion

In conclusion, an executor can rely on the advice of a professional as to whether a return is required, but not as to when a return is due (unless that advice is specifically sought). The personal representative is responsible, in most jurisdictions, for the timeliness of the return, regardless of his experience or knowledge of the law. Although courts have indicated that illness could be adequate reason for delay, they have not yet permitted a taxpayer to avoid penalties on that account. The blamelessness of the beneficiaries of the estate will not excuse an executor's delinquency, and neither litigation nor lack of funds constitutes reasonable cause.

It is expected that in may instances the administrative burden of preparing and filing the estate tax return will fall on the attorney for the estate, even though the executor is legally liable. Thus, it is in the best interest of the legal profession and the individual lawyer that an estate tax return receive proper priority.

Diane Hubbard Kennedy

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[166]Although the administrator did not have control of the funds given by the decedent during her lifetime, he must have controlled at least $40,000 or the estate would not have generated any tax liability.

Computation of Lost Future Earnings in Personal Injury and Wrongful Death Actions

The computation of lost future earnings has created a great deal of confusion and led to inconsistent holdings in both federal and state courts, but few jurisdictions have taken a less definitive position than Indiana. The purpose of this Note is to discuss the cases in which Indiana has dealt with four interrelated issues concerning the type of evidence admissible in computing lost future earnings in personal injury and wrongful death actions, as well as those cases decided by the federal courts and other state courts. The four issues to be discussed are as follows: (1) To what extent may expert testimony of future inflationary trends be used in the computation of lost future earnings? (2) To what extent may expert testimony as to probable increased productivity be used in the computation of lost future earnings? (3) May a jury be instructed that every award made to a party in a personal injury or wrongful death action for lost future earnings will not be subject to federal taxation? (4) May evidence of the impact of income taxes on future earnings be introduced to decrease any award for lost future earnings? The first two issues are often dealt with interchangeably by the courts. Therefore, they will be discussed together in this Note with distinctions being drawn whenever possible. Similarly, the third and fourth issues raising evidentiary questions relating to the impact of the tax laws on future awards will be discussed together as they raise comparable problems.

As a final matter, it is critical to an intelligible discussion of the issues in this Note to understand the basic system of damages in this country. Damages in wrongful death and personal injury litigation are based upon the theory of pecuniary reparation. The objective is to place the injured person in the same position, as nearly as possible with a monetary award, as he or she should have been in had the wrong not occurred.[1] This Note will explore how this system of damages is affected by the four factors to be discussed.

I. Inflationary and Productivity Factors

A. Introduction

Professors Harper and James suggest that the confusion surrounding awards of present damages for future loss is insoluble where there is a lump sum recovery.

Future trends in the value of money are necessarily

[1]*See* G. Parmele, Damage Verdicts, § 2 at 37-38 (1927); *see also* Chesapeake & O. Ry. v. Kelly, 241 U.S. 485 (1916).

> unknown and so always render such damages speculative in a way we cannot escape. If the estimates represent a straight-line projection of present living costs, they will be frustrated by fluctuations either way. If prophecy of change is heeded, frustration will follow if no change, or the opposite change, occurs. When courts have consciously grappled with the problem they have either found all prophecy too speculative and so, perforce, have taken the equally speculative course of betting on a continuance of the status quo; or they have made intuitive and not always very wise judgments that present conditions represent a departure from some imaginary norm to which they think we shall rapidly return.[2]

The courts often compound the problem by confusing inflation with productivity factors and by using the terms "inflation," "growth factor," "earnings increase factor," or "economic trends" to include both concepts of economic growth. To an economist, inflation is the percentage of rate of increase in the price level. "Productivity," on the other hand, depends on the industry a person is in. To ascertain the increase in productivity, the economist must assess "the contribution to wages that will derive for attendant increases in technologies peculiar to that industry."[3] Bascially, productivity appears to be a factor based on a worker's increased skill and output as he gains experience at a particular job and also the current improvements in technology which increase his output.[4] This Note will make distinctions whenever possible.

The United States Supreme Court has ostensively dealt with these factors in *Grunenthal v. Long Island Railroad*,[5] but the decision has not provided useful guidelines for lower courts. In *Grunenthal*, the Court upheld a damage award in an FELA case based upon projections of increased wage growth. The Court quoted the trial judge's conclusion that the plaintiff had presented "convincing testimony not refuted . . . demonstrating the steady wage increases in recent time for work equivalent to that rendered by plaintiff, and the strong likelihood that similar increases would continue."[6] This language does not elucidate whether the court was referring to inflation, productivity or both. As a result, the case has created confu-

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[2]II. F. HARPER & F. JAMES, THE LAW OF TORTS, 1325-26 (1956).

[3]Rall, *How to Prepare the Economic Evaluation Report*, TRIAL, April 1977, at 49.

[4]*See* Rall, *supra* note 3, at 47-53. *See also* Huddell v. Levin, 395 F. Supp. 64, 84 n.20 (1975); Hoffman v. Sterling Drug, Inc., 374 F. Supp. 850, 853 (M.D. Pa. 1974).

[5]393 U.S. 156 (1968).

[6]*Id.* at 160.

sion in the lower courts and has not been followed.[7] Furthermore, the case has been distinguished on the grounds that *Grunenthal* involved the question of whether a federal court had abused its discretion in approving the award as found by the jury, thus the issue as to the prejudicial nature of the testimony on future inflation was not raised.[8] The Supreme Court's opinion in *Grunenthal* is indicative of the confusion generated by these issues in other jurisdictions.

B. Indiana

Indiana has no reported decisions dealing directly with the admissibility of expert testimony and the use of inflationary and productivity factors in the computation of lost future earnings. However, there are several reported decisions in Indiana that indicate at least a tacit recognition of evidence of this type.

In *King's Indiana Billiard Co. v. Winters*,[9] the court of appeals upheld an award that the appellants contended was excessive, stating:

> The jury in assessing damages for loss of earnings is not limited to the amount being earned by the plaintiff at the exact time of his injury but may fairly compensate the plaintiff for such loss of earnings as he actually has and will sustain. . . .
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> . . . .
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> And, furthermore, the court on appeal will consider the diminished purchasing power of the dollar at the time the verdict is rendered.[10]

However, there was no evidence from the opinion that any testimony as to future economic trends had been offered. Also, while many reviewing courts have used judicial notice of inflation in justi-

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[7]One recent example is Henderson v. S.C. Loveland Co., 396 F. Supp. 658 (N.D. Fla. 1975), in which the court referring to the above quote, stated:

> While not clear from the decision, that evidence may not have been tied to inflation. In the case before this court, allowance was, of course, based on inflation. As appears from it's decision, there was no evidence before it of prior increases for work equivalent to that performed by plaintiff other than cost of living increases. *Penrod* and other recent Fifth Circuit decisions, though neither mentioning nor distinguishing *Grunenthal*, come several years after it. Without undertaking further to reconcile these decisions, if they need reconciliation, this court is constrained to follow, and will follow, the categorical statement of these recent decisions of the Fifth Circuit that the effect of future inflation is not to be considered in calculating future damages.

Id. at 660.

[8]*See* Raines v. New York R.R., 129 Ill. App. 2d 294, 263 N.E.2d 895 (1970), *rev'd on other grounds*, 51 Ill. 2d 428, 283 N.E.2d 230, *cert. denied*, 409 U.S. 983 (1972).

[9]123 Ind. App. 110, 106 N.E.2d 713 (1952).

[10]*Id.* at 124-25, 106 N.E.2d at 719.

fying an award claimed to be excessive, this question is distinct from the question of whether the jury should be allowed to consider the effects of possible future inflationary trends.[11]

In a more recent case, *State v. Daley*,[12] the court of appeals upheld the lower court's award based largely upon the uncontroverted testimony of an expert economist who had used an expected five percent wage increase factor in his computation of lost future earnings. Noting that the jury had apparently accepted the economist's projections as an accurate and fair calculation of the decedent's projected future earnings, the court stated: "An awareness of general inflation and a constant depreciation and cheapening of money is within the zone of discretion given to the trier of facts when assessing damages."[13]

In a subsequent case, *Richmond Gas Corp. v. Reeves*,[14] the court of appeals upheld a $250,000 verdict in a wrongful death action based upon a testimony of an actuary who had used a two percent annual wage increase factor in computing the projected future earnings of the twenty-six year old decedent. The court again emphasized, as it had in *Daley*, that the jury could consider such factors as general inflation and the constant depreciation and cheapening of money when assessing damages.[15]

It is significant that the *admissibility* of expert testimony on future inflationary trends or increased productivity was not raised in any of the above actions and that the court of appeals did not, in fact, decide this issue. Therefore, the results in the above cases may well be explained as an application of the liberal Indiana rule that damages will not be deemed excessive on review unless they are flagrantly outrageous and extravagant.[16] Thus, a subsequent case, which raised the admissibility issue, might well be distinguishable.[17] For this reason, it is necessary to look to other jurisdictions that

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[11]*See, e.g.*, Carol v. United States, 410 F. Supp. 378, 396-97 (D.R.I.), *aff'd*, 548 F.2d 366 (1st Cir. 1976).

[12]153 Ind. App. 330, 287 N.E.2d 552 (1972).

[13]*Id.* at 337, 287 N.E.2d at 556.

[14]158 Ind. App. 338, 302 N.E.2d 795 (1973).

[15]*Id.* at 369, 302 N.E.2d at 815.

[16]*See* State v. Daley, 153 Ind. App. 330, 287 N.E.2d 552 (1972), where the rule was set out that in order for damages to be ruled excessive on review they "must be so excessive as to strike mankind, at first blush, as being beyond all measure, unreasonable and outrageous, and such as manifestly show the jury to have been actuated by passion, partiality, prejudice, or corruption." *Id.* at 337, 287 N.E.2d at 556 (quoting Coleman v. Southwick, 9 Johns 45 (N.Y. Sup. Ct. 1812). *See also* Richmond Gas Corp. v. Reeves, 158 Ind. App. 338, 302 N.E.2d 795 (1973).

[17]For a case making a similar distinction, *see* Raines v. New York R.R., 129 Ill. App. 2d 294, 263 N.E.2d 895, *rev'd on other grounds*, 51 Ill. 2d 428, 283 N.E.2d 230, *cert. denied*, 409 U.S. 983 (1972).

have engaged in an in depth analysis of the factors favoring and opposing the use of inflationary and productivity factors in the computation of lost earnings for a more thorough discussion of these factors.

C. Federal Courts

1. First Circuit.—Although it has never addressed the issues of inflation and productivity factors separately, the First Circuit has rejected the admission of any evidence concerning the future trends of such factors for computations of future losses. The court in *William v. United States*[18] refused to increase future earnings by what it viewed as "some multiple taken out of the thin air in the name of future inflation."[19] The court argued that if evidence of the effect of future inflationary trends were considered, it would likewise be necessary to make an adjustment for possibly inflated expenses as well as earnings, and the court viewed both of these elements as too speculative. In a later decision, the court stated that consideration of "economic trends" would require the judge and jury to "take on the 'joint role of soothsayer and mathematical analyst in order to foretell what the future held for the deceased.' "[20] The most recent decision from a district court in the First Circuit adopted the rationale used by the court of appeals in rejecting any evidence concerning future inflationary trends and added the argument that the plaintiff could place his award in investments that gain a higher return than the statutory interest rate and thereby reduce any adverse effects of inflation.[21]

2. Second Circuit.—The Second Circuit has also held that inflation should not be considered in computing lost future earnings. In

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[18]435 F.2d 804 (1st Cir. 1970). *Williams* was a wrongful death action brought under the FTCA.

[19]*Id.* at 807. No reference was made in the opinion as to what, if any, expert testimony had been presented on the question of future inflation.

[20]Turcotte v. Ford Motor Co., 494 F.2d 173, 184 (1st Cir. 1974) (citing Romano v. Duke, 111 R.I. 459, 463, 304 A.2d 47, 51 (1973). *Turcotte* was an action brought under the Rhode Island wrongful death statute, which authorized a consideration of economic trends. Thus, while bound by state law to allow the use of inflationary and productivity factors, the court did note its general disapproval of such a statute.

[21]Caron v. United States, 410 F. Supp. 378, 396-97 (D.R.I. 1976). While *Caron* was a personal injury action governed by Michigan law, the district court noted that it found Michigan law on the evidentiary issue no different than the existing law in the First Circuit. The court also rejected the appellant's contention that prior decisions permitting the court to take judicial notice of inflation indicated such evidence was admissible. The court stated that such cases stood only for the proposition that the courts may take notice of rising prices due to past inflation in order to justify large verdicts against a charge of excessiveness. This is what the language in the Indiana decisions appears to suggest.

McWeeney v. New York, New Haven & Hartford R.R.,[22] the Second Circuit noted in dictum that although "some courts have sanctioned instructions permitting the jury to take into account inflation between the injury and the trial, there is little or no authority in favor of charging the jury to take future inflation into account."[23] The court thus justified the trial court's refusal to give any instruction on income taxes, in part on the ground that any windfall to the plaintiff would be offset by lack of adjustment for inflation. Judge Lumbard, concurring in part and dissenting in part, added that such evidence is too speculative and that any plaintiff receiving a large amount could invest the award in a manner that would give him some protection against both inflation and deflation.[24] However, the court of appeals did indicate in a subsequent case that it felt the courts might have to reconsider the propriety of receiving evidence on inflation if inflation should continue at its present pace.[25]

Nevertheless, two recent cases based on Connecticut law permitted extensive expert testimony on the question of inflation. In *Perry v. Allegheny Airlines, Inc.*,[26] the plaintiff's expert economist was permitted to use estimates of prospective future earnings testified to by the decedent's employer and to make "certain assumptions concerning future rates of inflation and interest" in arriving at the net economic loss for future earnings.[27] The opinion did not specify what these assumptions were or upon what they were based.

The Connecticut District Court was later faced with the converse of the question of whether the fact finder should consider inflation in evaluating the loss of future earning capacity, that being whether inflation should be considered in setting the interest rate by which the already assessed dollar amounts for the loss of future earning capacity were to be discounted to their present value. The district court approved the use of such an "inflation adjustment" in setting a discount rate.[28]

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[22]282 F.2d 34 (2d Cir.), *cert. denied*, 364 U.S. 870 (1960). The court's main focus in this case was whether the evidence should be limited to plaintiff's net income in an FELA action.

[23]*Id.* at 38.

[24]*Id.* at 42-43 (Lumbard, C.J., dissenting in part & concurring in part).

[25]Yodice v. Koninklijke, Nederlandsche Stoomboot Maatschappij, 443 F.2d 76 (2d Cir. 1971), *cert. denied*, 411 U.S. 933 (1973).

[26]489 F.2d 1349 (2d Cir. 1974).

[27]*Id.* at 1351.

[28]Feldman v. Allegheny Airlines, Inc., 382 F. Supp. 1271 (D. Conn. 1974), *aff'd in part, rev'd and remanded on other grounds*, 524 F.2d 384 (2d Cir. 1975). The district court had relied on an economic expert's calculation in which the expert had used average earnings of 4.14% as representative of a prudent, non-sophisticated investment and subtracted 2.87% as the yearly inflation rate, yielding a 1.27% difference, which was rounded up to 1.5%.

However, the court of appeals, in affirming the district court's decision, made it clear that the case should not be considered a precedent for cases arising under federal law, stating: "As a matter of federal law we do not necessarily vouchsafe either the principle of making an 'inflation adjustment' in setting a discount rate or the means by which it was done in this instance."[29] The court of appeals avoided an analysis of the reliability and speculativeness of the evidence provided by the plaintiff's economist by relying on the state's law giving the court the flexibility to consider inflation. Apparently the court of appeals agreed with the district court that the Connecticut law requiring discounting to present value for destruction of future earnings capacity compelled the court to "engage in economic forecasting despite the inexactitude of the dismal science's soothsaying."[30] Finally, another factor in the willingness of the court in both decisions to permit the inflation adjustment was the requirement under Connecticut law that future income taxes be deducted from any award.[31] Thus, the converse of the argument previously used in *McWeeney* was not available to the court in *Feldman*. It therefore appears that although the two recent cases based on Connecticut law seem to indicate more of a readiness to accept evidence incorporating inflationary and productivity factors, the Second Circuit's present position as expressed in *McWeeney* is that such evidence is too speculative.[32]

3. Third Circuit—The Third Circuit's Position, while not totally clear, appears to be that evidence of inflationary trends and increased productivity may only be admitted after a strict foundation has been laid to insure as much reliability in such projections as possible. The Third Circuit has also exhibited more of a readiness to accept evidence as to productivity increases than as to inflationary trends. In *Magill v. Westinghouse Electric Corp.*,[33] the court rejected an actuary's computations that incorporated an "earnings increase factor," stating that "the lack of foundation for the earnings

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[29]524 F.2d at 387.

[30]382 F. Supp. at 1293 n.30.

[31]The court of appeals noted that it felt the district court had appropriately hypothesized the Connecticut Supreme Court's favorable reaction to discount rate adjustment, "since Connecticut, unlike most jurisdictions, reduces what would otherwise be inflated judgments for wrongful death injuries by requiring deduction of income taxes payable on future earnings." 524 F.2d at 387.

[32]This conclusion is supported by Judge Friendly's concurring opinion in *Feldman*, where, after pointing out that utilization of an inflation rate in determining the discount rate gives nearly the same result as does first considering inflationary effects on future income and then discounting to present value, he expressed his concern that such method poses the problem of potential speculativeness in calculating damages. *Id.* at 390-93.

[33]464 F.2d 294 (3d Cir. 1972).

increase factor was a fatal defect."[34] In dicta, the court did indicate a greater willingness to accept evidence of productivity factors as opposed to inflationary factors, noting that it considered evidence of promotions or pay raises as a proper foundation upon which to gauge an increase in future earnings.[35]

A somewhat stronger case rejecting the use of inflationary trends as too speculative was *Frankel v. United States.*[36] In rejecting the offered evidence of inflationary trends, the court specifically criticized the use of an unusual time period by the plaintiff's expert in making his projections. Furthermore, the court indicated that the government's present attempts to control inflation and the fact that any award could be invested so as to offset the effects of inflation were factors weighing against admissibility.[37] The court's criticism at least impliedly indicates that such evidence might have been permitted if a proper foundation had been laid.[38] This conclusion is further supported in a subsequent court of appeals decision, *Hoffman v. Sterling Drug, Inc.*,[39] in which the court rejected evidence offered by the plaintiff's expert as too conjectural. In *Hoffman*, no evidence was introduced in the case as to the problability or magnitude of future inflationary trends. The court specifically criticized the economic expert's attempt to isolate a five year period of extreme inflation as the basis for a projection over twenty-six years without introducing any evidence to support such a projection.[40]

On remand after the Third Circuit's decision, the plaintiff argued that the court of appeals in *Magill* and the present case had found error in admitting testimony based on such a brief span of time and that they should not be precluded from introducing evidence of economic trends from a twenty year time span.[41] The court first noted that the confusion that existed in this area was

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[34]*Id.* at 300.

[35]However, the court specifically noted that the concept of inflation and the declining value of the dollar had almost been universally rejected as providing support for the earnings increase factor. Also central to the court's holding was the fact that the expert used was only an actuary and the method of calculations used was one used by accountants for a somewhat different purpose. *Id.* at 300-01.

[36]321 F. Supp. 1331 (E.D. Pa. 1970), *aff'd. sub nom.*, Frankel v. Heym, 466 F.2d 1226 (3d Cir. 1972). In *Frankel* the district court noted that inflationary considerations had been used in the justification of an award by considering present inflationary trends as compared to awards in the past, but they had not been used to project future earnings.

[37]The plaintiff's expert had used the decade of the 1960's, one of the more inflationary times in the history of our country, as the basis for his projection. *Id.* at 1346.

[38]*See also* Griffin v. United States, 500 F.2d 1059, 1070 (3d Cir. 1974).

[39]485 F.2d 132, 144 (3d Cir. 1973).

[40]*Id.* at 143-44.

[41]374 F. Supp. 850, 853 (M.D. Pa. 1974).

partially due to an imprecision of terms used, acknowledging that often the expressions "earnings increase factor" and "economic trends" are incorrectly used interchangeably by the courts. The former actually constitutes merit raises predicted over the plaintiff's life expectancy, while the latter reflects economic trends separate from the individual's employment situation.

The district judge indicated that the trial court error in the original *Hoffman* trial and in *Magill* was not the court's refusal to allow evidence on future economic trends "but rather our admission into the record of an earnings increase factor based on insufficient evidence. A close reading of *Magill* bears this out. Judge Adams' opinion in *Magill* carefully distinguishes between future earning power and future inflation."[42] On remand, the trial court rejected the defendant's argument that *Frankel* precluded all evidence on economic trends in computing loss of future earnings and stated that despite the difficulties involved the earnings increase factor of a particular plaintiff must be separated from future economic trends. Thus, the court would allow the plaintiff to present evidence to the jury as to the earnings increase factor but would not allow into evidence any testimony as to future economic trends, regardless of the foundation laid for it.[43]

However, a recent decision by another district court in the Third Circuit, *Huddell v. Levin*,[44] interprets *Magill* and *Hoffman* as standing merely for the proposition that a proper foundation must be laid to support the expert's opinion by showing specific evidence of long-range inflationary trends and wage increases in a particular job. The court rejected the defendant's argument that *Hoffman* and *Magill* prohibited the admission of testimony based upon growth rates while permitting the jury to consider future growth of earning capacity. In distinguishing *Huddell* from *Magill* and *Hoffman*, the court stated that it interpreted the two cases to mean merely that there must be competent evidence of probable future salary or economic trends, and evidence alone that growth had occurred in the past was not sufficient for this purpose. Thus, while *Magill* and *Hoffman* had disallowed the expert testimony for, in essence, not laying a proper foundation, the expert used in *Huddell* gave "the jury substantial evidentiary support for an award of damages based upon future growth of earnings. A more highly qualified expert in

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[42] *Id.* at 854.

[43] *Id.* at 855.

[44] 395 F. Supp. 64, 83-84 (D.N.J. 1975), *remanded on other grounds*, 537 F.2d 726 (3d Cir. 1976) (quoting Hoffman v. Sterling Drug, Inc., 485 F.2d 132, 144 (3d Cir. 1973)). *Huddell* was a wrongful death action brought under New Jersey law in which the court upheld an award based on expert testimony using a six percent "growth rate" factor, which was made up of a three percent inflation factor and a three percent standard of living increase.

this field could not have been produced."[45] The two most recent district court decisions from the Third Circuit have concurred with the district court's interpretation in *Huddell* of the decisions in *Magill* and *Hoffman*, stating: "[B]oth cases imply clearly that future increases in earnings is a proper matter for the jury so long as there is sufficient competent evidence of 'probable future salary trends or economic trends.' "[46]

4. Fourth Circuit.—The Fourth Circuit has not dealt directly with the issues under consideration, but a district court did consider them in *Scruggs v. Chesapeake & Ohio Railway*.[47] The court permitted the use of evidence regarding inflationary and productivity factors, stating that such factors were clearly relevant to the question of lost future earnings. The court reasoned that since inflation is a universally discussed topic, the jury was likely to consider whether there was testimony directed to the issue or not. Therefore, it was proper to admit expert testimony to guide the jury, since they would take it into account in any event.[48] The district court concluded that inflation and productivity factors are relevant evidence and are no more speculative than other factors used to determine future damages.

5. Fifth Circuit.—The Fifth Circuit has considered the issue more often than any other circuit. It has rejected the use of productivity and inflationary factors as too speculative. However, there has been some indication in dicta that the court may accept evidence as to increased productivity provided a strict foundation is first laid to insure the reliability of such evidence. In *Johnson v. Penrod Drilling*

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[45]*Id.* at 83-84. The court of appeals, when remanding, did quote with approval a recent New Jersey decision, Tenore v. Nu Car Carriers, Inc., 67 N.J. 466, 481-84, 341 A.2d 613, 621-23 (1975), in which the New Jersey court had indicated that so long as the plaintiff had an opportunity to offer expert testimony to give the jury informed guidelines in their deliberations, such evidenced was no more conjectural than other evidence often introduced to the jury. Furthermore, consideration of well informed estimates of future inflationary trends would lead to fairer damage awards. *Id.* at 83-84.

[46]Thomas v. American Cystoscope Makers, Inc., 414 F. Supp. 255, 270 (E.D. Pa. 1976) (quoting Hoffman v. Sterling Drug, Inc., 485 F.2d 132, 144 (3d Cir. 1973)). *See also* Vizzini v. Ford Motor Co., 72 F.R.D. 132 (E.D. Pa. 1976).

[47]320 F. Supp. 1248, 1250-51 (W.D. Va. 1970). *Scruggs* was an action brought by the widow of a deceased employee in which an economic expert had testified that he had projected a five percent wage increase each year based on a two percent productivity increase and a three percent inflationary increase.

[48]*Id.* at 1250-51. *See also* Plant v. Simmons Co., 321 F. Supp. 735 (D. Md. 1970). The only other cases found in the Fourth Circuit were Scheel v. Conboy, 551 F.2d 41, 43 (4th Cir. 1977), and Whalen v. Marini, 542 F.2d 1170 (4th Cir. 1976). In both cases, the court merely rejected any testimony by economic experts on future economic loss because of the speculativeness of determining in each case whether any future economic loss had in fact occurred.

Co.,[49] the Fifth Circuit, en banc, rejected the use of expert testimony by an economist on the question of inflation. The court took judicial notice that inflationary conditions had existed for a number of years, but concluded that inflation was not a predictable condition for the future. In reaching this conclusion, the court considered two factors. First, past increases in inflation do not necessarily foretell future inflationary trends but could as easily lead to a recession. Second, the government has launched strong counter measures aimed at curbing inflation.[50] The court also pointed out that inflation is accompanied by high interest rates, which could compensate for failure to compute an inflationary surcharge in wage rate calculations.[51] To support its conclusion, the court cited Professors Harper and James' treatise on torts.[52]

Finally, the court intimated that the admission of testimony on future trends would open the door to other similarly speculative and debatable offsets, such as possible future taxes or future deflation.[53] In conclusion, the court stated: "We expressly disapprove the district court's attempt to take into account, in computing the plaintiffs' future lost earnings, inflationary trends in this nation's economy for the next several decades."[54] The *Johnson* decision has been followed by a multitude of Fifth Circuit decisions,[55] including its most recent decision in *Higginbotham v. Mobil Oil Corp.*[56] The

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[49]510 F.2d 234, 235-41 (5th Cir. 1975). In *Johnson* the plaintiff's economist projected an annual wage of 4.8% and the defendant's expert had countered that such a figure was too high, and that it was impossible to predict inflationary trends accurately.

[50]Judicial notice was also taken of price controls temporarily instituted in 1971 and current legislative advocacy of tax rebates as a means of counteracting a contemporaneous business recession in support of the proposition that, since government policies might intervene at any time to change or control the direction of the economy. The assumption of inflation over the next 34 year period was totally speculative.

[51]510 F.2d at 236.

[52]*Id.* at 239. *See* note 2 *supra* and accompanying text.

[53]510 F.2d at 241-42 (citing McWeeney v. New York, N.H. & H. Ry., 282 F.2d 34 (2d Cir.), *cert. denied*, 364 U.S. 870 (1960) & Sleeman v. Chesapeake & O. Ry., 414 F.2d 305 (6th Cir. 1969)).

[54]510 F.2d at 241.

[55]*See* David v. Hill Eng'r Inc., 549 F.2d 314, 331-35 (5th Cir. 1977) (also specifically disallowing productivity factor as too speculative); Matter of S/S Helena, 529 F.2d 744, 753 (5th Cir. 1976); Lacaze v. Olendorff, 526 F.2d 1213, 1222 (5th Cir. 1976); Petition of M/V Elaine Jones, 513 F.2d 911, 912 (5th Cir. 1975); Standefer v. United States, 511 F.2d 101, 107 (5th Cir. 1975); Robertson v. Douglas Steamship Co., 510 F.2d 829, 839 (5th Cir. 1975); Consolidated Mach., Inc. v. Protein Prod. Corp., 428 F. Supp. 209, 227 (M.D. Fla. 1976); Henderson v. S. C. Loveland Co., 396 F. Supp. 658, 662 (N.D. Fla. 1975). *Cf.* Law v. Sea Drilling Co., 510 F.2d 242, 251 (5th Cir. 1975) (recognizing *Penrod* but applying pre-*Penrod* law).

[56]545 F.2d 422, 433-34 (5th Cir. 1977).

plaintiff's expert economist used a five percent annual straight-line estimated salary increase to calculate the probable future earnings of the decedent.[57] On appeal, the defendant argued that the five percent straight-line annual increase amounted to a hidden inflation-based award. Plaintiff contended that such a figure represented awards in recognition of performance and experience. In reversing and remanding the case to the district court to give the plaintiff an opportunity to prove her damages for loss of her husband's future earnings, the court set out the following standard:

> We believe that *Johnson v. Penrod Drilling Co.* and its progeny likewise stand for the proposition that courts may not simply assume that projected wage increases—whether calculated from the decedent's past earning experience or by some other means—would have been granted solely in "recognition of performance and experience." To the contrary, to recover at all for future raises plaintiff must bear the difficult burden of proving what portion of the increases would have been given other than as an automatic hedge against inflation.[58]

While the opinion clearly implies that evidence of increased productivity may be allowed, the court concludes with the cautioning statement: "It remains, of course, within the trial judge's discretion to reject any testimony concerning future wage increases as too speculative . . . ."[59]

6. *Sixth Circuit.*—Although early Sixth Circuit decisions flatly rejected the use of inflationary or productivity factors as too speculative, recent decisions indicate a trend toward allowing the jury to consider future inflation under certain circumstances. The outstanding case in this area is *Sleeman v. Chesapeake Railway Co.*,[60] an FELA injury case. The district judge did not discount Sleeman's award for future earning capacity, because an economist had testified in other cases in his court that there was "jurisdiction for offset of discount to present worth of future earnings by increased

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[57]The economist had arrived at the five percent figure by calculating the annual percentage increases in the decendent's salary from the time he began working for his employer until death. *Id.* at 435.

[58]545 F.2d at 434-35.

[59]*Id.* at 435. Justice Godbold dissented, criticizing the court's original decision in *Johnson* and stating that where evidence of past wage increases are introduced a court should clearly be entitled to conclude that the pattern of past earnings increases is of sufficient duration and uniformity to be a reliable basis for an inference with respect to the future, despite the fact it may embrace in that pattern certain cost of living increments. *Id.* at 437.

[60]414 F.2d 305, 307-08 (6th Cir. 1969).

earning and appreciation factors."[61] The court of appeals found that the district court's decision lacked evidentiary support. The court recognized that the economic history of the nation since the 1930's would appear to make the exclusion of such factors somewhat unfair to the plaintiff, but suggested that the inflation versus deflation debate, which has raged inconclusively at the highest levels of government, was unlikely to be resolved in one personal injury trial. As a result, the court of appeals would not allow the trial courts of its circuit to explore such unresolved speculative issues.[62]

In a recent Sixth Circuit decision, *Bach v. Penn Central Transportation Co.*,[63] the court modified its position in *Sleeman*. The court indicated that the district court was correct in rejecting specific testimony offered by plaintiff's economic expert[64] as being too speculative to be admissible. However, the court of appeals held that the trial court had committed reversible error in instructing the jury that it could not consider the effect of inflation based on the jurors' knowledge of it. In rejecting the economist's evidence, the court stated:

> In recent history inflation has been so persistent that it is difficult to conceive that the purchasing power of the dollar might remain constant through the year 2000. On the other hand, the predictive abilities of economists have not advanced so far that they can forecast with any certainty the existence and rate of inflation for the next thirty years. Limited use of economists and other experts may be appropriate in some cases to show that raises in income or promotions would most probably occur.[65]

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[61] Sleeman v. Chesapeake & O. Ry., 290 F. Supp. 817, 829 (W.D. Mich. 1967).

[62] 414 F.2d at 308. The court also cited with approval the same passages from Harper & James that had been cited by the Fifth Circuit in *Johnson*. *See* note 2 *supra* and accompanying text.

In a later decision, Willmore v. Hertz Corp., 437 F.2d 357, 360 (6th Cir. 1971), the court modified its position somewhat when it found the appellant's reliance on *Sleeman* with references to future fluctuation in purchasing power was misplaced, as the court was applying state law. The court noted that the discussion in *Sleeman* of the consideration of current economic trends in awarding future damages was actually dictum, because the reversal resulted from the district court's failure to reduce future damages to their present worth. However, there was no indication in the *Willmore* opinion that expert testimony was actually offered. *See also* Petition of United States Steel, 436 F.2d 1256, 1280 (6th Cir. 1970), *cert. denied*, 402 U.S. 987, *rehearing denied*, 403 U.S. 924, 940 (1971).

[63] 502 F.2d 1117, 1122 (6th Cir. 1974).

[64] The economist had projected the exact income the decedent would have received through the year 2002 based on his knowledge of the railroad industry and estimates of future inflation. *Id.* at 1122.

[65] *Id.*

The language quoted above implies that evidence as to productivity increases might well be allowed.

The opinion contained even stronger dicta indicating that the court might accept a more generalized exposition of the economic factors involved in computing future cost earnings:

> We do not hold, however, that the jury may never consider inflation and future increases in income in determining damages. . . . If a jury is not permitted to consider decreases in the purchasing power of money, appellant would be woefully damaged if inflation should continue at its present or at any other substantial rate. . . . The court's role is to keep such extrapolations within reasonable bounds and insure they conform to evidence. . . .
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> . . . Inflation is a fact of life within the common experience of all jurors. Admittedly, if the jury considers this issue without expert testimony, their calculations will be even more imprecise.[66]

This language, though dicta, would suggest that the Sixth Circuit may be moving away from its position in *Sleeman*. After its decision in *Bach*, the Sixth Circuit may allow the jury to consider future inflation based on either the jurors' own knowledge or on general information supplied by an economist, so long as the economist's evidence is not in the form of precise computations of damages set forth by economic analysis.

7. *Seventh Circuit.*—The Seventh Circuit has never directly addressed the question of whether expert testimony would be allowed concerning the use of inflationary and productivity factors in the computation of future lost earnings. However, in *Wetherbee v. Elgin, Joliet & Eastern Railroad*,[67] the court of appeals did express concern regarding the increasing size of personal injury awards:

> The way the amounts awarded in verdicts in personal injury cases have been rapidly increasing is a matter of concern to all who are interested in a fair and orderly administration of justice. . . . Even allowing for the decreased purchasing power of the dollar, many of the recent large awards for damages are not justified.[68]

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[66]*Id.*

[67]191 F.2d 302 (7th Cir. 1951).

[68]*Id.* at 309. The reference to allowing for decreased purchasing power of the dollar refers to the use of comparison of past awards with present awards to determine if such award is excessive and has no bearing on the question of whether inflationary and productivity factors may be considered in computing lost future earnings. *See* Frankel v. United States, 321 F. Supp. 1331, 1345-46 (E.D. Pa. 1970), *aff'd*, 466 F.2d 1226 (3d Cir. 1972).

This would indicate that the court would not be anxious to approve any new methods of computations that would encourage juries to return even higher verdicts.

8. *Eighth Circuit.*—The Eighth Circuit has essentially adopted the same position followed by the Sixth Circuit. Thus, while the use of specific evidence is rejected as too speculative, the use of evidence of productivity increases is permitted if a proper foundation is provided. The Eighth Circuit has also shown a willingness to allow the jury to consider the dollar's diminished or increased purchasing power. The court first addressed the issue in *Riha v. Jasper Blackburn Corp.*,[69] a diversity action brought under Nebraska law. After quoting extensively from the Sixth Circuit's opinion in *Bach* v. *Penn Central Transportation Co.*,[70] the court concluded that even under the more liberal approach suggested by *Bach*, the evidence of future inflation was too speculative to be admitted under both federal and Nebraska law.[71] In *Johnson v. Serra*,[72] a diversity action brought under Minnesota law, the court cited *Bach* again in holding that the lower court had abused its discretion in allowing the plaintiff's expert to testify using computations that provided for an annual wage increase.[73] The court noted that such evidence was too conjectural and speculative and therefore lacked sufficient probative value to outweigh the danger that it would lead the jury to assess damages on an improper basis. Furthermore, the court indicated that it viewed inflationary forecasts of economists as only personal opinions of the meaning of past trends, which may well be faulty indicators of the future.[74]

The court went on to point out that nearly all federal courts dealing with federally created claims, such as FELA or Jones Act cases, have rejected testimony, jury instructions, or trial court consideration of any kind of future inflationary trends in damage assessments, while some state courts, or federal courts applying state laws, have permitted consideration of inflation. The court concluded its discussion of the question with the following statement:

> In sum, Dr. Foster's testimony in the instant case, as that in the Bach case, lacked sufficient evidentiary founda-

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[69]516 F.2d 840 (8th Cir. 1975). In *Riha*, the plaintiff's expert had used a 4.4% inflationary factor and a 7% annual wage increase factor in his computations. *But see* Beanland v. Rock Island & P. R.R., 480 F.2d 109, 117 (8th Cir. 1973) (Bright, J., concurring).

[70]502 F.2d 1117, 1122 (6th Cir. 1974).

[71]516 F.2d at 845.

[72]521 F.2d 1289 (8th Cir. 1975).

[73]*Id.* at 1293. The expert had taken the average wage increases for teamsters since 1947 (a 5.6% increase) and used the annual yield on conservative investments (4.1%) to yield a differential of 1.5% in his computation.

[74]*Id.* at 1294.

> tion—*as projections of distant future inflationary trends inevitably must.* His testimony on future inflationary projections to the year 2002 should, therefore, have been excluded as speculative and the excessive verdict obviously derived from it must be reduced or, in the alternative, a new trial granted.[75]

9. *Ninth Circuit.*—Two recent decisions by the Ninth Circuit clearly indicate that expert testimony on changing economic trends is admissable where a proper foundation is laid. In *United States v. English,*[76] a wrongful death action under California law, the court of appeals found that the trial court had erred in not reducing the award to present value, but in dictum approved the admissability of expert testimony on the effect of inflation on future damages. While recognizing it was controlled by California law, the court of appeals stated it would be compelled to reach the same result under federal law for several policy reasons. First, the court acknowledged that it is somewhat speculative to attempt to forecast future inflationary trends, but the court suggested that most predictions about future income are equally suspect. The court reasoned that since it is more likely that there will be changes in the value of the dollar than not, it is better to try to predict these changes than to ignore them altogether. Second, the court recognized that many of the cases in other districts originally rejecting the use of evidence pertaining to inflation awards were decided at a time when inflation was not considered as such an integral part of our economic lives. Thus, to ignore inflation was viewed to be the same as predicting it would not occur, or that its effect would be de minimis. Although recognizing that the administrative convenience of ignoring inflation has some appeal when inflation rates are low, the court stated that "to ignore inflation when the rates are high is to ignore economic reali-

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[75]*Id.* at 1296-97 (citations omitted) (emphasis added). While *Riha* and *Serra* appear to adequately express the Eighth Circuit's view on the question of admissibility of evidence as to future inflationary trends, notice should be taken of two subsequent cases allowing such evidence. In Raney v. Honeywell, Inc., 540 F.2d 932 (8th Cir. 1976), a case decided under Iowa law, the court upheld an award based on computations made by plaintiff's expert that relied upon an inflationary rate and a discount rate of six percent to cancel each other out. The court distinguished *Raney* from *Riha* and *Serra,* noting that they both had been based on state laws that did not permit such evidence, whereas Iowa law permitted evidence of inflation to be considered by the jury in determining the diminution in the plaintiff's earning capacity. The other case was Morrow v. Greyhound Lines, Inc., 541 F.2d 713 (8th Cir. 1976), in which an award based on expert testimony on inflation was affirmed because the appellant failed to make any objection on that ground to the admissibility of the testimony at the trial court.

[76]521 F.2d 63 (9th Cir. 1975).

ty."[77] The court concluded on a cautionary note, making it clear that juries could not use inflation as an excuse not to reduce an award to present value. Furthermore, the court added that consideration of inflation was proper only where sound and substantial economic evidence is offered to support any estimates on the future purchasing power of the dollar.[78]

The court put what had been dicta into practice in *Burlington Northern, Inc. v. Boxberger*,[79] although no reference was made to the prior decision. The court held that it was within the trial court's discretion to determine whether the expert's sources of information were sufficiently reliable to warrant reception of the opinion and that under the circumstances presently before the court, the expert's testimony clearly did not reach the level of the "rampant speculation" they had condemned in previous decisions.[80] The court also noted that the asserted defects in the expert's assumptions were questions for the jury, and the defendant had been protected by competent cross-examination.

10. Tenth Circuit.—The Tenth Circuit, in perhaps one of the most complete reviews of recent cases dealing with the questions under discussion, adopted the position of the Ninth Circuit, permitting evidence of inflationary and productivity factors to be admitted

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[77]*Id.* at 75.

[78]The court specifically stated:

> By today's holding that the trier of facts in awarding damages may take into consideration estimated changes in the purchasing power of money, we do not mean to imply that the lower court may use our holding as an excuse not to discount an award to its net present value. In other words, the court may not assume that the discount rate and the inflation rate will net to zero. The lower court must first estimate future income and expenses, taking into account estimated changes in the purchasing power of the dollar, and then discount this future net income stream to its present value. Nor do we intend to have our holding of today read as authorizing the court to arbitrarily draw an estimate of inflation out of thin air. As with any other element of damages, we must require the estimate of future inflation to be supported by competent evidence. The court is to be especially wary of the pitfalls signposted by the court in *Bach*, which are inherent in making predictions about the future of economic conditions. By our holding we allow the trier of fact in awarding damages to take into account only such estimates of future changes in the purchasing power of money as are based on sound and substantial economic evidence, and can be postulated with some reliability.

Id. at 75-76 (citations omitted).

[79]529 F.2d 284 (9th Cir. 1975). *Boxberger* was an FELA case arising under Oregon law in which the plaintiffs had computed lost future earnings based on the assumption that a 4.8% compound annual increase in railroad employee's earnings over the next 34 years would occur. The expert's estimate was based upon government data on the average earnings of railroad engineers.

[80]*Id.* at 287.

upon the laying of a proper foundation.[81] In *Steckler v. United States*,[82] an action brought under the Federal Torts Claim Act, the trial court had heard testimony by plaintiff's economist as to a future inflationary factor of 9.5%.[83] Nevertheless, the court rejected the plaintiff's contention that there should be an increase in the award based on the anticipated inflation, concluding that an award reflecting the effect of inflation on future earning capacity would be improper as too speculative. The court of appeals, while noting that the lower court was justified in rejecting the 9.5% inflation factor, stated that it was not justified in altogether rejecting the evidence of an infaltionary trend. Although the court acknowledged that the majority of courts do require a reduction to present value in calculating damages for future benefits lost and at the same time do not allow the effects of inflation on future benefits to be considered, the court stated that this position was inconsistent and often criticized. The court reviewed the various recent decisions and concluded that it would follow the approach of the Ninth Circuit.[84] Thus, the Tenth Circuit will consider evidence of inflationary trends in conjunction with the problem of discounting the ultimate inflated sum so as to reduce it to its present value.

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[81]However, in a decision from a district court in the Tenth Circuit, DeWeese v. United States, 419 F. Supp. 170 (D. Colo. 1976), which was rendered before the Fourth Circuit had an opportunity to consider the issue, Judge Winner presented one of the strongest and most vehement arguments against the use of an inflationary factor in the computation of lost future earnings. Judge Winner stated that he was unconvinced anyone could foretell economic conditions 45 years down the road, noting the 45 years ago the United States was at the bottom of the Great Depression, that in 1931 a transcontinental telephone call cost about $20 and one could mail 4,000 letters for the same amount, whereas today such a call could be made for $1.50, but only 155 letters could be mailed for $20. After acknowledging that much of the uncertainty in this area was the result of cases confusing inflation and reasonable job progression he concluded:

> The divergent views create a quagmire . . . I think that inflationary trends and predictions espoused by "econometrists" testifying as advocates have no place in a lawsuit. The award of damages in a wrongful death or personal injury case is an approximation at best, and testimony confidently predicting economic conditions many years in the future is more likely to be wide of the mark than it is to approximate justice. Of course, the long range price trend has been on the upside historically, but where it is going in the future is anyone's guess.

Id. at 174-75.

[82]549 F.2d 1372 (10th Cir. 1977).

[83]The 9.5% factor did not include any factor for proficiency increases or promotions.

[84]In remanding, the court indicated that the trial court should determine a reasonable annual percentage rate for computing probable wage inflation from the evidence, suggesting that the Bureau of Labor Statistics Reports would be a reliable rough guide for the trial court's consideration of a reasonable inflation rate.

D. State Courts

1. State Courts Not Allowing Consideration of Economic Trends.—The state courts that have addressed the question of the admissibility of expert testimony dealing with inflationary and productivity factors in computing future lost earnings have more readily accepted such testimony than the federal courts. Perhaps the most often cited state decision disallowing such testimony is *Raines v. New York Central Railroad.*[85] The court in *Raines* had allowed the plaintiff's expert to testify to the jury as to past economic trends, describing inflation, the increase in prices and wages, and the devaluation of the purchasing power of the dollar. On direct examination, the expert witness also testified that in his opinion the inflationary spiral would continue to affect the price level by approximately two to four percent. The plaintiff argued on appeal that such testimony was permissible based on previous Illinois decisions that held that a reviewing court would take judicial notice of the decline in purchasing power of money in considering an issue of excessive damages. The appellate court rejected this argument on the grounds these cases were easily distinguishable and did not justify permitting a jury to consider the effect of possible future inflationary trends. However, the Illinois Supreme Court later reversed the appeallate court decision, stating that before evidence of future inflationary trends may even by considered as erroneous, the reviewing court must determine that the verdict is not supported by other evidence.[86] Thus, the Illinois Supreme Court, without reaching the propriety of the admission of evidence concerning inflation, held that there was other proper evidence sufficient to support the verdict.[87]

One other recent case representative of state court decisions finding error in admitting evidence of inflationary or productivity factors is *Havens v. Tonner.*[88] The plaintiff's expert in the lower court had computed the plaintiff's lost future earnings based on a 3.5% "productivity factor." In reversing the judgment the court stated:

> Steadily rising wage rates over the next twenty years, whatever the cause, are simply one face of the coin of inflation. It may be that inflation will become so much an established pattern of our economy that it should be recognized in estimating loss of future earnings. Certainly,

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[85]129 Ill. App. 2d 294, 263 N.E.2d 895 (1970), *rev'd,* 51 Ill. 2d 428, 283 N.E.2d 230 (1972).

[86]51 Ill. 2d 428, 283 N.E.2d 230, *cert. denied,* 409 U.S. 903 (1972).

[87]*See also* Kapeladi v. Alton & S. R.R., 36 Ill. App. 3d 37, 343 N.E.2d 207 (1976).

[88]243 Pa. Super. Ct. 371, 365 A.2d 1271 (1976).

> the erratic behavior of the economy over the past half dozen years, plagued by war and other unusual circumstances, is not a sufficient demonstration that inflation at any predictable rate will continue for another twenty years. Furthermore, even if inflation is a part of the pattern of the future, one certain consequence is that interest rates on money will reflect that fact. Consequently, a sum representing the present worth of future earnings will earn more in dollars in an inflationary period than would otherwise be the case. This may not wholly compensate for the effect of inflation but it is a closer and more certain approximation than any assumption of a certain rate of inflation over the next twenty years. We view the "productivity factor" as simply a substitute for inflation and equally speculative and inadmissible in a calculation of future earnings.[89]

Other recent state cases prohibiting testimony of future inflationary trends follow basically the same reasoning.[90]

2. State Courts Allowing Consideration of Economic Trends.—A somewhat novel approach among these states taking into consideration the effect of inflationary and productivity factors is *Beaulieu v. Elliott*[91] in which the Alaska Supreme Court held the rate of depreciation in the value of the dollar, attributable to ongoing inflation, approximately offsets the financial windfall otherwise attributable to a failure to discount to present value. The court suggested that such procedure was also justified by possible future wage increases.[92]

Federal courts and other state courts allowing evidence of future inflationary trends follow basically the same line of reasoning.[93] There have also been a number of state courts specifically ap-

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[89]*Id.* at 378, 365 A.2d at 1274.

[90]*See* Freeman v. Lanning Corp., 61 Mich. App. 527, 233 N.W.2d 68 (1975); Mississippi Power & Light Co. v. Shepard, 285 So. 2d 725 (Miss. 1973); Atwood v. Lever, 274 So. 2d 146 (Miss. 1973); Segebart v. Gregory, 160 Neb. 64, 69 N.W.2d 315 (1955). *But see* Hampton v. State Highway Comm'n, 209 Kan. 565, 498 P.2d 236 (1972); Washington v. American Community Stores Corp., 196 Neb. 624, 244 N.W.2d 286 (1976); Zaninovich v. American Airlines, Inc., 26 App. Div. 2d 155, 271 N.Y.S.2d 866 (1966).

[91]434 P.2d 665 (Alaska 1967).

[92]*See also* State v. Guinn, 555 P.2d 530 (Alaska 1976).

[93]*See* Loetzerich v. Texas Pac.-Mo. Pac. Terminal R.R., 325 So. 2d 626 (La. Ct. App. 1976); Morgan v. Liberty Mutual Ins. Co., 323 So. 2d 855 (La. Ct. App. 1975); Lumber Terminals, Inc. v. Nowakowski, 36 Md. App. 82, 373 A.2d 282 (1977) (excellent discussion of recent state decisions); Rafferty v. Weimer 36 Md. App. 98, 373 A.2d 64 (1977); Tenore v. Nu Car Carriers, Inc., 67 N.J. 466, 341 A.2d 613 (1975); Williams v. General Motors Corp., 501 S.W.2d 930 (Tex. Ct. App. 1973); Hinzman v. Palmanteer, 81

proving the introduction of expert testimony on both increased future inflation and productivity.[94]

II. Income Taxes

A. Introduction

Awards received by settlement or verdict in death actions or personal injury actions are not taxable under the federal income tax laws.[95] This has led to controversy in almost every state and federal court as to the proper consideration to be given taxes in computing damage awards. Professors Harper and James have noted: "With anything as sure as 'death and taxes,' the courts are avoiding their responsibilities when they decline to make the best guess they can, once all the reasonably available evidence has been brought before them."[96] The majority of legal commentators clearly advocate that evidence of the amount of federal income tax that a plaintiff would pay on probable future earnings should be taken into account in computing the damage award.[97] However, the majority view of the courts has been that it is reversible error even to inform a jury that a plaintiff's award is not taxable. Consequently, very few courts have allowed the portion of the award representing compensation for loss of future earnings to be reduced by an amount the plaintiff would have been required to pay as income taxes had the plaintiff received that sum is income over the future years.

The propriety of instructing the jury that any awards made to the plaintiff will not be subject to federal income tax (based on the idea that such an instruction is to prevent a jury from adding to an award an amount it erroneously believes the plaintiff will be called upon to pay for income taxes) is a distinct and separate issue from that of whether evidence of the impact of such taxes may be shown to reduce the amount of the award. However, these two issues are often raised in the same case, and occassionally the courts will erroneously fail to distinguish them.[98] Therefore, these two issues will

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Wash. 2d 327, 501 P.2d 1228 (1972) (but see strong dissent against award of loss of value of future earnings capacity); Sadler v. Wagner, 5 Wash. App. 77, 486 P.2d 330 (1971).

[94] *See* Schnebly v. Baker, 217 N.W.2d 708 (Iowa 1974); Coco v. Winston Indus., Inc., 341 So. 2d 332 (La. 1976); Resner v. Northern Pac. Ry., 161 Mont. 177, 505 P.2d 86 (1973) (but see dissent); Turrietta v. Wyche, 54 N.M. 5, 212 P.2d 1041 (1949); Wilson v. Wylie, 86 N.M. 9, 518 P.2d 1213 (Ct. App. 1974); Ploud v. Southern Pac. Transp. Co., 266 Or. 666, 513 P.2d 1140 (1973), *aff'd on rehearing*, 272 Or. 35, 534 P.2d 965 (1975).

[95] I.R.C. § 104(a)(2).

[96] Harper & James, *supra* note 2, § 25.12 at 1327.

[97] *See, e.g.*, Harper & James, *supra* note 2, § 25.12 at 1326-27; Morris & Nordstrom, *Personal Injury Recovery and the Federal Income Taxes Law*, 46 ABA J. 274 (1960).

[98] *See, e.g.*, Highshew v. Kushto, 235 Ind. 505, 134 N.E.2d 555 (1956).

be treated together in this Note. Some cases have distinguished or limited the application of their opinions on the tax issues to wrongful death cases, while others have spoken in general terms that apply to both personal injury actions and wrongful death actions.

B. *Indiana*

The law in Indiana on both issues dealing with the nontaxability of awards is as uncertain and confusing as it is on the questions of the use of inflationary and productivity factors. In *Highshew v. Kushto*,[99] the court of appeals reviewed a judgment for the plaintiff in a personal injury case in which the trial court had refused to give cautionary instruction concerning the non-taxability of the award:

> If given, the cautionary instruction would have informed the jury that in the event they found for the plaintiff any award made to him would not be subject to federal income taxes. *Such an instruction has been approved by the courts of Missouri, and we can find no reason for the disapproval of the one here involved.* It is obvious, however, that a refusal to give the instruction could only result in an excessive verdict due to the jury's desire to make the appellee whole after taxes. *The verdict in this case is not excessive and we are constrained to conclude that any error involved in the refusal to give instruction in question was harmless.*[100]

However, the Indiana Supreme Court, in denying a petition to transfer,[101] expressly disapproved the language emphasized in the above quotation. The court concluded that cautionary instructions such as those suggested by the court of appeals would raise collateral issues and require intricate instructions on tax and non-tax liabilities. As a result, no court would be able to properly instruct a jury without a tax expert at its side.[102]

The Indiana Supreme Court's decision in *Highshew* has been cited by a number of other courts as an example of an opinion that fails to recognize the distinction between the evidentiary issues concerning the consideration of the income tax impact on awards and the question of the propriety of a cautionary instruction concerning the non-taxability of the award.[103] A recent Indiana Court of Appeals

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[99]126 Ind. App. 584, 131 N.E.2d 652, *transfer denied*, 235 Ind. 505, 134 N.E.2d 555 (1956).

[100]134 Ind. App. at 596, 131 N.E.2d at 657 (citations omitted) (emphasis added).

[101]235 Ind. 505, 134 N.E.2d 555 (1956).

[102]*See also* Richmond Gas Corp. v. Reeves, 158 Ind. App. 338, 302 N.E.2d 795 (1973).

[103]*See, e.g.*, Domeracki v. Humble Oil Ref. Co., 443 F.2d 1245 (3d Cir. 1971).

decision diplomatically recognized this failure when it affirmed a lower court award where a cautionary instruction had been given. While recognizing that under the *Highshew* opinion it was improper to give such an instruction, the court stated:

> Clearly, an instruction regarding the income tax consequences of an award of damages can have two meanings. . . . They were not entitled to an inflated award based upon the jury's mistaken belief that a portion of the verdict would be used to pay taxes on the amount recovered. The instruction given, in conjunction with the other instructions, merely served to caution the jury to base its award on the evidence, and not on speculation about tax consequences.[104]

From the language of the above cases it would appear Indiana would hold that any evidence of the impact of income taxes on future earnings was inadmissible. However, such language is arguably dicta since it was raised in an opinion concerning the propriety of a cautionary instruction. Likewise, the opinion indicates no cautionary instruction would be allowed, although the recent court of appeals decision implies that such an instruction might be allowed if the court properly distinguishes the two issues.

C. *Federal Courts*

1. *First Circuit.* — While the case law is not entirely clear, the First Circuit appears to permit the jury to consider the impact of taxes in those cases where future inflationary trends are considered. Furthermore, the First Circuit has held that it is not error to refuse to give a cautionary instruction on the non-taxability of the award, unless there is some indication in the record that the jury award was based on the assumption the award was taxable.

The question of whether evidence of future income taxes should be admitted first arose in *Boston & Maine Railroad v. Talbert.*[105] In the case, the court of appeals excluded the evidence, citing a Second Circuit decision[106] that had held such deductions to be too conjectural. However, in a recent decision under Rhode Island law, which expressly authorizes the consideration of inflation and other economic trends, the court concluded that whatever savings accrued to the plaintiff by excluding evidence on the "taxation bite" would be increased by the inflation multiplier.[107] As a result, the court of

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[104]Wickizer v. Medley, 348 N.E.2d 96, 99-100 (Ind. Ct. App. 1976).

[105]360 F.2d 286 (1st Cir. 1966).

[106]Stokes v. United States, 144 F.2d 82 (2d Cir. 1944). *See* discussion in text accompanying notes 117-18, *infra.*

[107]Turcotte v. Ford Motor Co., 494 F.2d 173 (1st Cir. 1974).

appeals reversed the trial court's decision that failed to make reductions in projected earnings for federal and state income taxes. The court pointed out that the forecasting of future inflationary rates was clearly more speculative than the forecasting of future tax rates, and it would thus be logically inconsistent to require considerations of future inflation while at the same time disallowing evidence as to tax savings on the grounds that it was too speculative to compute future tax rates.[108]

In its most recent decision on the evidentiary issue, *Kennett v. Delta Airlines, Inc.*,[109] the First Circuit quoted extensively from both the majority and dissenting opinions in a leading Second Circuit decision.[110] The court indicated that it favored the dissenting opinion's argument that such evidence should be considered, but refused to apply that rule in the case under consideration because no evidence as to future taxes had been submitted at the trial court level.[111] In *Kennett*, the First Circuit also discussed the propriety of an instruction cautioning the jury that the award was not taxable and upheld the trial court's refusal to give such an instruction. The court recognized that this was a proper statement of the law, but argued it would inject an "irrelevant" factor in the jury's determination of damages. However, the court did note that it would be error not to give the instruction if it could be demonstrated from the record that the jury assumed the award was taxable.[112]

2. Second Circuit.—The Second Circuit has upheld a trial court's refusal to give a cautionary instruction where there was no evidence that this affected the jury's award and has suggested that in certain circumstances the jury may properly consider the tax consequences on future earnings. Both issues were raised in *McWeeney v. New York, New Haven & Hartford Railroad*,[113] one of the most frequently cited opinions in this area of the law. In *McWeeney*, the defendant requested both a cautionary instruction regarding the

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[108] *Id.* at 184-86. *But cf.* Caron v. United States, 410 F. Supp. 378 (D.R.I. 1976) (personal injury case decided under Michigan law in which the court held a recent Michigan decision foreclosed any argument as to the propriety of taking into consideration the impact of income taxes on a personal injury award).

[109] 560 F.2d 456 (1st Cir. 1977).

[110] McWeeney v. New York, N.H. & H. R.R., 282 F.2d 34, 35-43 (2d Cir.), *cert. denied*, 364 U.S. 870 (1960).

[111] 560 F.2d at 463-64.

[112] *Id.* at 461-62. Such a statement by the court seemed inconsistent with the record, which indicated a strong likelihood that the jury did assume the award was taxable, as the jury specifically asked the trial court whether they should consider income tax deductions in computing future lost earnings and the court informed them they should not consider them. The logical conclusion from such an exchange would appear to be that such an award is taxable. *But see id.* at 462 n.7.

[113] 282 F.2d 34 (2d Cir.), *cert. denied*, 364 U.S. 870 (1960).

non-taxability of the award and an instruction directing the jury to calculate any future loss of earnings on the basis of the plaintiff's net income after deduction of income taxes. The court of appeals affirmed the denial of both requests by the trial court.

The court first discussed the instruction concerning the deduction of taxes and held that the impact of income tax liability should not be considered in computing the damage award because it would prove too difficult for the jury. "Practical difficulties," such as disputes over possible future exemptions resulting from marriage and newly born children, as well as tax shelters, would make any result merely speculative.[114]

The court also noted that if consideration of such a factor were allowed, there would be an additional problem resulting from the fact that lost future earnings awards are discounted to present value to account for the earning power of money. Since interest so computed would be taxable, another adjustment would have to be made in the award to add back in the taxes that would be paid on such interest.[115]

Arguing in support of the instruction, the defendant contended that regardless of how difficult the computation would be, the worst result from giving such an instruction would be better than the best result from not giving one. The court rejected the defendant's contention based on three justifications. First, it would be too conjectural to determine future tax liability in light of such factors as changes in the family status of the injured party in years to come, possible changes in the exemption and deduction provisions of the tax law, possible changes in the rates of taxation, and so forth. Second, the use of a net income theory would be too complex and confusing for the jury. And finally, other factors not considered in the computation, such as inflation and attorneys fees, would tend to counter-balance any resulting overcompensation.[116]

The court did, however, modify its position taken earlier in *Stokes v. United States*.[117] *Stokes* is often cited for the proposition that the amount of federal income taxes is too conjectural to be considered by a jury. In *Stokes*, the court made no analysis of the question, but was content to settle the problem by merely stating that "such deductions are too conjectural."[118] In *McWeeney*, the court noted that in cases involving computation of income in higher tax brackets, where added exemptions or deductions do not greatly af-

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[114]*Id.* at 36.
[115]*Id.* at 37.
[116]*Id.* at 38.
[117]144 F.2d 82 (2d Cir. 1944).
[118]*Id.* at 87.

fect the tax, failure to make some adjustment for the portion of a plaintiff's or decedent's earnings that would have been taken by income taxes would produce an improper result. The court stated:

> In such cases . . . the criticism that the whole process of computation is unrealistic has a considerable measure of validity, the projection of future income at such levels being itself extremely conjectural, and the slope of the tax progression curve declines although only after having reached such a high plateau that earnings above it have relatively slight value.[119]

Concluding its discussion of the issue by acknowledging that the practice of refusing the instructions in some cases, but requiring adjustments in others, lacked precision and elegance, the court nevertheless left the decision to the trial judge.[120]

The *McWeeney* court then discussed the refusal of the trial court to caution the jury as to the non-taxability of the award. The court concluded there would be no error in giving such an instruction as it was a correct statement of the law that imposed no new burdens on the jury and did not require the jury to engage in speculation. Nevertheless, the court held it was not reversible error to refuse to give the instruction, stating: "Before an appellate court should hold that the failure to give such a cautionary instruction was reversible error, there ought to be evidence either that juries in general increase recoveries on this account or that the particular jury did so."[121]

Chief Judge Lumbard wrote an excellent dissent discussing both issues. Concerning the cautionary instruction, Lumbard argued it was the duty of the courts to "charge upon those matters regarding which misinformation by any one juror might lead the jury to give improper weight to a factor which should not be considered at all."[122] Taking judicial notice that media coverage of large sums won on television or in lotteries often pointed out that a large percentage of the winnings must be paid to the government as income tax, Lumbard reasoned that it would only be natural for the layman to conclude that the plaintiff's receipts from the judgment would be taxed.

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[119]282 F.2d at 38-39.

[120]*See also* Blake v. Delaware & H. Ry., 484 F.2d 204 (2d Cir. 1973). *But see* J. Lumbard's dissent, *id.* at 207-08, advocating a re-examination of *McWeeney. See also* Petition of Marina Mercante Nicaraguense, S.A., 364 F.2d 118 (2d Cir.), *cert. denied,* 385 U.S. 1005 (1966); Leroy v. Sabena Belgian World Airlines, 344 F.2d 266 (2d Cir.), *cert. denied,* 382 U.S. 878 (1965) (applying *McWeeney* exception to a geologist with an anticipated income of between $16,000 and $25,000).

[121]282 F.2d at 39.

[122]*Id.* at 40 (Lumbard, C.J., dissenting).

This danger, combined with the fact that such a request requires no calculation or computation and is simple and easily understood, led Lumbard to conclude that refusal to grant such a request was reversible error.

Lumbard further concluded that an instruction to consider tax savings should be granted if the defendant produces some evidence as to what the plaintiff actually paid in the past or as to what taxes would normally be paid by someone in the plaintiff's position. He claimed the majority greatly overestimated the difficulties that the jury would encounter in making such a computation. Furthermore, Lumbard rejected the majority's contention that such a factor was too speculative, pointing out that all items of damages listed by the majority (future normal earning power, expectancy and discount factor) were sheer speculation as to any plaintiff. Nevertheless, it would be unfair to omit any one of them merely because they were speculative. Lumbard noted that "on the facts of this case one thing is certain and that is that McWeeney never has escaped and never could expect to escape the payment of income taxes on any money which he has earned or would earn in the future" and that "[n]othing can be more certain than that there will be a federal income tax in the years to come and that it will be substantially what it is now and what it has been for many years."[123] Lumbard concluded that given the fact that a minimum of fifteen to twenty percent of an individual's gross income is generally paid on taxes it seemed unfair to deny an instruction as to future income taxes when such an instruction is requested and the record contains evidence as to taxes.[124]

3. Third Circuit.—The Third Circuit will allow a cautionary instruction when requested, but it will prohibit the introduction of evidence concerning possible future income taxes to reduce the award. The court of appeals in *Domeracki v. Humble Oil & Refining Co.*[125] noted that evidence of income taxation was to be excluded, but held that in personal injury actions the trial court must, upon request by counsel, give a proper cautionary instruction. The court stated that the purpose of personal injury compensation is neither to reward the plaintiff nor punish the defendant but to replace the plaintiff's losses resulting from the injury. An injured plaintiff loses

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[123]*Id.* at 41-42.

[124]For an earlier decision decided under Oklahoma law that supports Lumbard's dissent see O'Connor v. United States, 269 F.2d 578 (2d Cir. 1959). *See also* Perry v. Allegheny Airlines Inc., 489 F.2d 1349 (2d Cir. 1974); Feldman v. Allegheny Airlines, Inc., 382 F. Supp. 1271 (D. Conn. 1974), *aff'd in part, rev'd & remanded on other grounds,* 524 F.2d 384 (2d Cir. 1975).

[125]443 F.2d 1245 (3d Cir. 1971).

only his net or take-home pay and does not in fact "lose" his gross earnings. While acknowledging that legal commentators generally advocate the admissibility of such evidence, the court suggested that "shifting tax rates, together with other variables, could give rise to great conjecture, at least as to *en futuro* earnings. Indeed, the tax computation itself could completely overshadow the basic issues of liability and damages."[126] Thus, while realizing that such a practice may result in the plaintiff being overcompensated, the court chose to follow the majority of jurisdictions in allowing evidence only of gross earnings.[127]

In discussing the second issue concerning instructions on the taxability of the award, the court noted that while some courts have confused the evidentiary issue with the question of a cautionary instruction,[128] the issues are distinct. The court pointed out that the cautionary instruction did not require additional evidence or a tax expert and would not open the trial to matters irrelevant to traditional issues in personal injury litigation. Thus, it would in no way complicate the case or confuse the jury. The court concluded that the "tax conscious" American juror might well believe that the judgment would be taxable and would increase the verdict to compensate for the imaginary tax. Therefore, the court required the use of a cautionary instruction in the future if it is requested by counsel.[129]

A district court in a recent case, *Huddell v. Levin*,[130] discussed the evidentiary issue at length and considered many of the objections that have been raised regarding evidence offered on future taxes. The court rejected this evidence on several grounds. First, the court indicated that the majority of courts clearly prohibited this type of evidence.

> In all but one state, the gross earnings rule is followed. In twenty-eight states, the question has been specifically considered. In twenty-seven of those states, the courts have ruled either that income tax consequences cannot be considered, or have accepted the majority rule that cautionary instructions should not be given concerning the non-taxability of the award. Nor is there any case decided under

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[126]*Id.* at 1250.

[127]It should be noted that such language was dicta, as the issue before the court was the refusal of the trial court to grant the requested cautionary instruction.

[128]The court cited Highshew v. Kushto, 235 Ind. 505, 134 N.E.2d 555 (1966), as an example of a case confusing the two issues. *See* text accompanying notes 101-03 *supra*.

[129]*See also* Vizzini v. Ford Motor Co., 72 F.R.D. 132 (E.D. Pa. 1976), *remanded on other grounds*, 569 F.2d 754 (3d Cir. 1977).

[130]395 F. Supp. 64 (D.N.J. 1975), *rev'd on other grounds*, 537 F.2d 726 (3d Cir. 1976).

> "federal" law where the jury's consideration of income tax consequences has been permitted. In non-jury cases decided under "federal" law, there appears to be only two exceptions to the majority rule. The only area where authority is evenly divided is Federal Tort Claims Act cases, where the United States as defendant is also the benefactor of the exemption.[131]

Second, the *Huddell* court viewed the exemption for such awards found in the tax laws as an expression by Congress of a desire to give a benefit to victims of tortious conduct. The court recognized that such awards may have initially been excluded because of constitutional reservations as to their taxability, but subsequent cases have established that Congress can constitutionally tax any gain.[132] Since Congress re-enacted the exemption after these decisions, the court argued that this indicated that Congress "intended to relieve a taxpayer who has the misfortune to become ill or injured."[133]

The court's third rationale was that the "collateral source" doctrine found in the law of evidence[134] prohibited consideration of the intended benefit of the Congressional exemption, as "the incidence of federal taxation on personal injury awards is a matter solely between plaintiff and the Government."[135] The court therefore conclud-

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[131]*Id.* at 85-86 (footnotes omitted). It should be noted that this quote fails to include those cases that have allowed the consideration of taxes under the *McWeeney* Rule, nor does it note several decisions which state that the evidentiary issue of taxes is not affected by whether the case is before a jury or judge. *See* Mosley v. United States, 538 F.2d 555 (4th Cir. 1976); McWeeney v. New York, N.H. & H. R.R., 282 F.2d 34 (2d Cir. 1960) (Lumbard, C.J., dissenting).

[132]*See, e.g.*, Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).

[133]395 F. Supp. at 87 (quoting Epmeier v. United States, 199 F.2d 508, 511 (7th Cir. 1952)). Professor Nordstrom has strongly attacked this argument, stating that the Congressional intent argument is merely an example of attributing a non-existent intent to a legislative act after the fact. In support of this view, he pointed out that such provision did not appear in our tax laws until 1918, and when it did so its purpose was not to benefit injured parties but rather it appeared because Congress thought it was doubtful that tort damages were income within the meaning of the Sixteenth Amendment. Nordstrom, *Income Taxes and Personal Injury Awards*, 19 OHIO ST. L.J. 212 (1958). Nordstrom does not meet the argument raised in *Huddell* that re-enactment of the exclusion after the rulings resolving the doubt as to whether tort damages were income indicates a Congressional intent to benefit the injured party; nor does *Huddell* show any indication of such an intent.

[134]Under the "collateral source rule," the defendant is not entitled to obtain the benefit of payments that have come from a collateral source, that is, a source that is collateral to, or independent of, the defendant. *See, e.g.*, Weiman v. Ippolito, 129 N.J. Super. 578, 324 A.2d 582 (1974).

[135]395 F. Supp. at 88. Professor Nordstrom likewise points out the fallacy of this argument and states that, while it is correct that what a plaintiff does with an award

ed that the jury should be concerned only with plaintiff's total losses and not with what might have happened to those earnings had he not been injured. The court thereafter merely reiterated the arguments raised in *McWeeney*.

In a recent personal injury action, *Varlack v. SWC Caribbean, Inc.*,[136] the Third Circuit rejected the argument that evidence of taxes on future earnings should be admitted, but failed to make any reference to the district court's argument in *Huddell*. Instead, the court relied on the rationale found in *McWeeney* that such evidence would be too complex and conjectural.

4. Fourth Circuit.—The Fourth Circuit has permitted the use of evidence on income taxes in computing damages in wrongful death cases but has not otherwise addressed the issues under consideration. However, the district courts of the circuit have applied the *McWeeney* Rule to the evidentiary issue in personal injury cases and have permitted cautionary instructions in both types of actions.

In *Mosley v. United States*,[137] a wrongful death action governed by North Carolina law, the court of appeals held that evidence of income taxes would be permitted. While noting that the issue had not been directly addressed by the North Carolina Supreme Court or by the court of appeals itself, the Fourth Circuit stated: "[W]e are of the opinion that income taxes are proper deductions in order to arrive at the 'pecuniary injury' retrievable by the estate."[138] This case is one of the few decisions which made a clear distinction between the admissibility of such evidence in wrongful death actions and its admissibility in personal injury cases. The court adopted the rationale previously expressed by the district court in *Brooks v. United States*,[139] which rejected the contention that evidence of future tax impact was too speculative in wrongful death cases. While acknowledging that changes in tax deductions (such as increases in dependents) may make it impossible to arrive at a fair calculation of future tax in personal injury cases, the court suggested that such arguments have little relevance in wrongful death actions. Both *Brooks* and *Mosley* were non-jury cases, but the courts

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after receipt is of no concern to the court, it is not correct to assume that the plaintiff's award is an accurate measure of his loss. His true loss is, rather, his net income. Nordstrom, *supra* note 133. The Second Circuit in Perry v. Allegheny Airlines, Inc., 489 F.2d 1349 (2d Cir. 1974), also rejected the argument that the collateral source rule barred such evidence, noting that the admissibility of evidence regarding income taxes does not present the general equitable considerations underlying the collateral source rule.

[136] 550 F.2d 171 (3d Cir. 1977).

[137] 538 F.2d 555 (4th Cir. 1976).

[138] *Id.* at 558-59 (footnote omitted).

[139] 273 F. Supp. 619 (D.S.C. 1967).

indicated that even a jury could deal with the complexities and confusion involved in admitting such evidence.

In *Plant v. Simmons Co.*,[140] decided before *Mosley*, the district court adopted the *McWeeney* Rule and prohibited the introduction of tax evidence. This approach has been modified by the Fourth Circuit's opinion in *Mosley* with respect to wrongful death actions. However, this will most likely be the rule in this circuit as to personal injury actions. *Plant* also recognized in dicta that a cautionary instruction should be given when requested by either side.[141]

5. *Fifth Circuit.*—The Fifth Circuit has also adopted the *McWeeney* Rule on the evidentiary issue but has chosen not to allow a cautionary instruction. There does appear to be, however, a substantial dissenting minority on both positions.

In *Blue v. Western Railway*,[142] the court of appeals addressed the evidentiary issue in some depth. In *Blue*, the plaintiff claimed the trial court had committed error by instructing the jury to consider and compute only the amount of net wages lost as a result of the injury. The court of appeals acknowledged that the rationale of those courts prohibiting the use of evidence of future taxation had been severely criticized by Harper and James.[143] Furthermore, the court indicated that such evidence was no more speculative than many of the other items that go into prophecies about future losses. Nevertheless, the court held that evidence of future taxes should not be allowed except under certain circumstances, quoting the *McWeeney* decision in its entirety for support. The court concluded that the rule enunciated in *McWeeney* was sound and in harmony with their prior decisions.[144]

On the related question of the propriety of a cautionary instruction, the court noted it had already held in prior decisions that it was proper for the trial court to refuse such an instruction.[145] However, none of the Fifth Circuit decisions discuss the rationale of these holdings.

The majority's position on both the evidentiary question and the cautionary instruction has provoked substantial disagreement. In its most recent decision, *Johnson v. Penrod Drilling Co.*,[146] the majority

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[140]321 F. Supp. 735 (D. Md. 1970).

[141]*Id.* at 740.

[142]469 F.2d 487 (5th Cir. 1972).

[143]*See* note 96 *supra* and accompanying text.

[144]The court in *Blue* also distinguished a prior decision, Hartz v. United States, 415 F.2d 259 (5th Cir. 1969), which had allowed future taxes to be considered on the grounds that *Hartz* was a non-jury death action brought under the FTCA. Therefore, *Hartz* was a suit between an individual and the government, which legislated the tax break, as opposed to a personal injury action between private parties.

[145]*See, e.g.*, Greco v. Seaboard Coast Line R.R., 464 F.2d 496 (5th Cir. 1972).

[146]510 F.2d 234 (5th Cir.), *cert. denied*, 423 U.S. 839 (1975).

of the Fifth Circuit, en banc, adhered to the *McWeeney* Rule. Three of the judges dissented on the income tax issue, noting that by following *McWeeney* the court would "open to [the jurors] the gates of fairyland and direct them to arrive at a take-home earnings figure . . . which never was and never would have been. This . . . is not logic and should not be law."[147] The dissent further criticized the majority's practice of not allowing an instruction to the jury concerning the non-taxability of the award, noting that such a practice could result in a double windfall for the plaintiff, first by allowing him to receive an award based on gross earnings, and second, by allowing a mistaken jury to add a factor which would never in fact have to be paid.

6. *Sixth Circuit.*—The Sixth Circuit has taken a position similar to the Fourth Circuit. It has adopted the *McWeeney* Rule on the evidentiary issue and requires that requested cautionary instructions be given. In *Petition of the United States Steel Corp.*,[148] a proceeding involving claims for the death of seamen and injuries to others under maritime law, the court of appeals rejected any consideration of the impact of income taxes on the computation of lost future earnings as too speculative, and stated: "[W]e therefore adopt the [*McWeeney* Rule] that no adjustment for income tax need be made 'at the lower or middle reach of the income scale.' "[149]

Later, in *Bach v. Penn Central Transportation Co.*,[150] the court addressed the propriety of a cautionary instruction. The court recognized that in a number of previous cases it had held it was not reversible error to refuse to give such an instruction.[151] However, the court held it was within the trial court's discretion whether to give such an instruction or not, since such an instruction does not involve speculation or complicated calculations and merely gives the jurors an accurate statement of the tax law.[152]

7. *Seventh Circuit.*—While the Seventh Circuit has not addressed the issue concerning the propriety of a cautionary instruction, it appears to have adopted the *McWeeney* Rule on the evidentiary issue. In *Wetherbee v. Elgin, Joliet, & Eastern Railway*,[153] a death action brought under FELA, the defendant had appealed the

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[147] *Id.* at 242 (Gee, J., dissenting).

[148] 436 F.2d 1256 (6th Cir. 1970).

[149] *Id.* at 1274 (quoting *McWeeney*, 282 F.2d at 39).

[150] 502 F.2d 1117, 1122-23 (6th Cir. 1974).

[151] *See, e.g.*, Hageman v. Signal L.P. Gas, Inc., 486 F.2d 479 (6th Cir. 1973); Payne v. Baltimore & O. R.R., 309 F.2d 546 (6th Cir.), *cert. denied*, 374 U.S. 827 (1962).

[152] 502 F.2d at 1123. *Cf.* Johnson v. Husky Indus. Inc., 536 F.2d 645, 650 (6th Cir. 1976) (different result under Tennessee law).

[153] 191 F.2d 302 (7th Cir. 1951), *rehearing denied*, 204 F.2d 755, *cert. denied*, 346 U.S. 867 (1953).

trial court's decision on grounds that the award was excessive. The defendant contended that the actuary's computation was based on the false premise that the descendants' loss of future benefits could be computed on the decendent's probable future gross earnings rather than his probable contribution for support. The court of appeals, after noting that the actuary's computations had in fact been based on the decedent's average past gross earnings rather than his "take-home" pay, concluded that it was error to receive this testimony over the defendant's objections. This implies that the tax factor should be taken into account in computing lost future earnings.

The court apparently modified its position somewhat in *Cox v. Northwest Airlines, Inc.*,[154] a non-jury action under the Death on High Seas Act. The trial court failed to reduce the decedent's projected future earnings by future income taxes. The Seventh Circuit remanded the decision with directions to modify the damages, adopting the rationale of the Second Circuit in *Petition of Marina Mercante Nicaraguense, S.A.*[155] In *Marina Mercante*, the Second Circuit stated that the *McWeeney* Rule should be followed in all cases where the question is one of federal law or the applicable state law is silent. Thus, even though *Cox* was a non-jury wrongful death action, its adoption of the rationale of the Second Circuit position indicates that the Seventh Circuit would apply the *McWeeney* Rule in both personal injury and wrongful death cases and in both a jury or non-jury setting.

8. *Eighth Circuit.*—The Eighth Circuit has indicated it would not permit evidence of income taxes but that the court might allow a cautionary instruction. However, none of the Eighth Circuit decisions discuss either issue in depth. *Chicago & Northwestern Railway v. Curl*,[156] a personal injury action brought under FELA, appears to be the only Eighth Circuit decision dealing with the evidentiary issue on taxes. The court of appeals in *Curl* held that the trial court was correct in refusing to receive appellant's offer of proof of appellee's average net earnings after deductions. In affirming the decision, the court merely cited to *Stokes v. United States*[157] for support of the proposition that such evidence is too conjectural.

In a more recent decision, *Raycraft v. Duluth, Missabe & Iron Range Railway*,[158] another personal injury action brought under the

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[154]379 F.2d 893 (7th Cir.), *cert. denied*, 389 U.S. 1044 (1967).

[155]364 F.2d 118 (2d Cir.), *cert. denied*, 385 U.S. 1008, *rehearing denied*, 386 U.S. 929 (1966).

[156]178 F.2d 497 (8th Cir. 1949).

[157]144 F.2d 82, 87 (2d Cir. 1944).

[158]472 F.2d 27 (8th Cir. 1973).

FELA, the appellant argued that the trial court had erred in refusing to give a requested cautionary instruction concerning the non-taxability of the award. The court noted that the Eighth Circuit had not previously expressed an opinion on the subject and that the law on the issue was unsettled. The court specifically refused to resolve the issue, stating: "Even if this panel were to adopt the instruction, this panel would do so only prospectively."[159] The court did indicate in a footnote that it viewed the *Curl* opinion as having held that the evidence of tax computation affecting gross income was improper.[160]

9. *Ninth Circuit.*—Although the Ninth Circuit has officially adopted the *McWeeney* Rule on the evidentiary issue, it is clear from its discussion in its most recent decisions that it favors the admissibility of such evidence.[161] It has also taken the position that cautionary instructions concerning the non-taxability of awards should be allowed. A recent opinion dealing with both issues, *Burlington Northern, Inc. v. Boxberger*,[162] is representative of the Ninth Circuit's position. In *Boxberger*, the trial court had refused to allow evidence of income taxes and rejected the defendant's request for a cautionary instruction. After reviewing the *McWeeney* decision at length, the court of appeals stated that under the compensatory theory of damages the windfall that the survivors would receive in tax-free dollars could not be justified either in fairness or logic.

The court noted several fallacies regarding the objections raised in *McWeeney* against the admission of evidence of future tax impact. First, the court rejected the primary objection that such evidence is too speculative and uncertain on the grounds it was no more speculative than other evidence submitted to the jury. Second, *McWeeney* had suggested that the calculation of future tax liability would be too confusing for the jury. The Ninth Circuit noted that jurors had experience in determining their own tax liability and the court was "confident that our juries and judges, with the aid of such competent expert testimony as may be received, are equal to the task and the responsibility."[163]

Finally *McWeeney* argued that any unfairness to the defendant resulting from the refusal to admit evidence of future tax consequences was counter-balanced by the unfairness to the plaintiff in not admitting evidence of inflation and not compensating the plaintiff for his attorney's fees. This rationale was not applicable to the Ninth Circuit, which had held that testimony as to future inflation

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[159]*Id.* at 33.

[160]*Id.*

[161]*See* Burlington N., Inc. v. Boxberger, 529 F.2d 284 (9th Cir. 1975).

[162]*Id.* The court also indicated that any problem with speculativeness could be reduced by careful court supervision of evidence admitted and instructions to the jury.

[163]*Id.* at 293.

was to be taken into consideration.[164] Furthermore, as to attorney's fees, the court indicated that the impact of these fees has no relation to the jury's task of estimating damages, unlike inflation and taxation, which clearly would have occurred had the decedent lived.[165] After indicating that fairness and logic would require a rule providing for the admissibility of, and corresponding deduction to account for, future income taxes in all cases, the court nevertheless concluded that the adoption of such a broad rule would go against the weight of authority. Therefore, the Ninth Circuit adopted the flexible *McWeeney* Rule.[166]

Subsequent to *Boxberger*, the Ninth Circuit decided *Felder v. United States*,[167] a death action brought under the FTCA and controlled by Arizona law, in which the court added a somewhat novel rationale for requiring the consideration of income taxes. The court argued that the failure to deduct income taxes in computing lost future earnings would result in an award of punitive damages that is impermissible under the FTCA.[168]

The Ninth Circuit has taken the position that a cautionary instruction should be allowed when requested. The court indicated that when all factors were considered the balance was overwhelmingly in favor of giving such an instruction. The court simply noted that the instruction could do no harm, and it could certainly help by preventing the jury from inflating the award on the erroneous assumption that the judgment would be taxable.[169]

10. Tenth Circuit.—The Tenth Circuit has not considered either issue in depth. However, it has ruled that both the consideration of tax savings in the computation of lost future earnings[170] and

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[164] *See* United States v. English, 521 F.2d 63 (9th Cir. 1975).

[165] 529 F.2d at 294. The court also distinguished the question of attorney's fees as follows: "Attorneys' fees are related to private contracts between the litigants and the attorneys. They have no legitimate relevancy as to what amount of money is justly compensatory for the loss resulting from the defendant's tortious act." *Id.*

[166] The court did hold, however, that under the *McWeeney* Rule taxes should have been considered in this case, which involved an income span of $18,048 to $40,000 in annual earnings. *Id.*

[167] 543 F.2d 657 (9th Cir. 1976).

[168] *Id.* at 669. The court distinguished two prior holdings, McCauley v. United States, 470 F.2d 137 (9th Cir. 1972), and United States v. Becker, 378 F.2d 319 (9th Cir. 1967), in which it had affirmed awards that had not deducted projected income taxes on the basis that in those cases the punitive damage issue had not been raised. *Id.* at 670.

[169] Burlington N., Inc. v. Boxberger, 529 F.2d at 297. In balancing the factors to be considered, the court held that the danger that the jury would assume the award was taxable and increase damage award to compensate for taxes combined with the fact that the instruction was neither time consuming nor confusing clearly led to the conclusion such instruction should be allowed. *Id.*

[170] *See* Sanchez v. Denver & R.G.W. R.R., 538 F.2d 304 (10th Cir. 1976), *cert. denied*, 429 U.S. 1042 (1977). *Sanchez* was a personal injury action brought under the

the giving of a cautionary instruction[171] are to be left to the trial judge's discretion.

11. District of Columbia Circuit.—The D. C. Circuit has no cases directly addressing either issue. However, in *Runyon v. District of Columbia*,[172] the court concluded that it was proper for the estate of the deceased to recover an amount based on probable net future earnings pursuant to the District of Columbia Survival Statute.[173] This net figure is computed by determining gross probable future earnings by use of actuarial tables, subtracting taxes and support, and then discounting the entire amount to present value. The court did not discuss the rationale for its decision at great length. In support of its conclusion, the court simply cited to several state decisions allowing such evidence and to Professors Harper and James' treatise on torts.[174]

D. State Courts

Floyd v. Fruit Industries,[175] decided by the Connecticut Supreme Court, is the leading state court decision upholding the admission of evidence of the impact of future taxes. The court stated that it could not conceive of a more unrealistic, unjust, or unfair rule than one that would lead a jury to base their computations of future earnings capacity on the hypothesis that no income taxes would be paid on net earnings. The court also rejected the argument that such evidence was too uncertain or conjectural, raising again the counter argument that such evidence is no more speculative than many of the other factors that must be submitted to the jury for consideration.[176] Several other states have reached the same conclusion as

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FELA in which the court of appeals simply noted that in some cases it would be unconscionable not to take income tax liability into account, and that conversely a similar result could occur if too great a deduction were applied. Therefore, the admissibility of such evidence was best left to the discretion of the trial court. *See also* DeWeese v. United States, 419 F. Supp. 170 (D. Colo. 1976).

[171]*See* Nichols v. Marshall, 486 F.2d 791, 794 (10th Cir. 1973). The court in *Nichols* held it was not error to refuse to give a cautionary instruction but acknowledged that neither would it be error to give such a "precautionary" instruction.

[172]463 F.2d 1319 (D.C. Cir. 1972).

[173]D.C. CODE §§ 16-2701 to -02 (1973) (current version at *id.* §§ 16-2701 to -02 (Supp. 1978)).

[174]463 F.2d at 1322 (citing HARPER & JAMES, *supra* note 96).

[175]144 Conn. 659, 136 A.2d 918 (1957). *Floyd* was a wrongful death action in which the trial court had instructed the jury to consider the offsetting factor of probable income taxes on decedent's probable earnings. *But cf.* Gorham v. Farmington Motor Inn, Inc., 159 Conn. 576, 271 A.2d 94 (1970) (trial court did not err in refusing to charge the jury that the verdict in a personal injury action would not be subject to income tax).

[176]144 Conn. at 666, 136 A.2d at 925. The court also rejected the plaintiff's contention that tax considerations would be more proper in a case involving a fatality than in a case not involving a fatality. *Id.* at 667, 136 A.2d at 926.

Connecticut, using the rationale found in *Floyd* and the federal decisions allowing such evidence.[177]

The Missouri Supreme Court's opinion in *Dempsey v. Thompson*[178] is the state court decision most often cited for the proposition that a cautionary instruction should be given. The court rejected the defendant's contention that taxes should be considered in arriving at the amount of the award. However, the court held that the defendant was entitled to have the jury instructed that the award was not subject to taxation. The court reasoned that most jurors are not only conscious of, but acutely sensitive to, the impact of taxes, while few persons have knowledge of the exemption allowed under federal law. Therefore, the court concluded it was reasonable to assume the jury would believe the award was subject to taxation.[179]

The state court decision most representative of those standing for the proposition that the court should allow neither evidence of future tax liability nor a cautionary instruction is *Hall v. Chicago & Northwestern Railway*,[180] a personal injury action brought under the FELA. The Illinois Supreme Court reasoned that since it is a general principle of law that the status of the parties in a trial is immaterial, it follows that whether the plaintiff has to pay a tax on the award is a matter that concerns only the plaintiff and the government. The court also argued that Congress' intent in enacting the exemption was to give an injured party a tax benefit. This benefit would be nullified if the jury were to reduce the plaintiff's damages to compensate for the tax exemption.[181]

In upholding the refusal to give a cautionary instruction, the Illinois Supreme Court acknowledged that there was a possibility that a defendant might be harmed if the jury made some type of adjustment for this imaginary tax. Nevertheless, the court preferred to rely on the presumption that the jury will not take into consideration any factors that they are not instructed to consider by the trial court. The court also rejected the argument that a cautionary instruction is proper merely because it correctly states the

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[177]Adams v. Deur, 173 N.W.2d 100 (Iowa 1969); Tenore v. Nu Car Carriers, Inc., 67 N.J. 466, 341 A.2d 613 (1975); Turrietta v. Wyche, 54 N.M. 5, 212 P.2d 1041 (1949); Wilson v. Wylie, 86 N.M. 9, 518 P.2d 1213 (Ct. App. 1973); Geris v. Burlington N., Inc., 277 Or. 381, 561 P.2d 174 (1977).

[178]363 Mo. 339, 251 S.W.2d 42 (1952). *But see* McBee v. Schlupbach, 529 S.W.2d 435 (Mo. Ct. App. 1975); Senter v. Ferguson, 486 S.W.2d 644 (Mo. Ct. App. 1972).

[179]For other cases holding evidence of income tax liability inadmissible but requiring a cautionary instruction, *see* High v. State Highway Dep't, 307 A.2d 799 (Del. 1973); Abele v. Massi, 273 A.2d 260 (Del. 1970).

[180]5 Ill. 2d 135, 125 N.E.2d 77 (1955).

[181]*Id.* at 152, 125 N.E.2d at 86.

law.[182] There have been numerous other state decisions reaching the same result on both issues.[183]

Only one state court appears to have adopted the *McWeeney* Rule on the evidentiary issue,[184] and a number of cases have simply refused to allow any evidence of probable future tax liability with no real discussion of an underlying rationale.[185] There have also been a number of states that have held that while it would be proper to give a cautionary instruction concerning the non-taxability of an award, the decision to give such an instruction is totally within the trial court's discretion.[186] However, the majority of state cases dealing with the single issue of the propriety of a cautionary instruction have expressed disapproval of such an instruction.[187]

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[182]The court noted this argument could be adopted *ad infinitum*, to allow innumerable instructions—for example that the expense of trial is not provided for, that the cost of medical witnesses is not paid by the defendant, etc., all of which are correct statements of the law. *Id.*

[183]*See, e.g.*, Mitchell v. Emblade, 80 Ariz. 398, 298 P.2d 1034 (1956); St. Johns River Terminal Co. v. Vadeu, 190 So. 2d 40 (Fla. Dist. Ct. App. 1966); Seaboard Coast Line R.R. v. Thomas, 125 Ga. App. 716, 188 S.E.2d 89 (1972); Atlantic Coast Line R.R. v. Brown, 93 Ga. App. 805, 92 S.E.2d 874 (1956); Green v. Texeira, 54 Haw. 231, 505 P.2d 1169 (1973); Cereal Byproducts Co. v. Hall, 16 Ill. App. 2d 79, 147 N.E.2d 383 (1958) (income tax refund cannot be considered in mitigation of damages); Spencer v. Martin K. Eby Constr. Co., 186 Kan. 345, 350 P.2d 18 (1960) (confusing evidentiary issue and cautionary instruction question); Lumber Terminals Inc. v. Nowakowski, 36 Md. App. 82, 373 A.2d 282 (1977); Briggs v. Chicago Great Ry., 248 Minn. 418, 80 N.W.2d 625 (1957); Eriksen v. Boyer, 225 N.W.2d 66 (N.D. 1974); Bergfeld v. New York, C. & St. L. R.R., 103 Ohio App. 87, 144 N.E.2d 483 (1956).

[184]Morgan v. Liberty Mut. Ins. Co., 323 So. 2d 855 (La. Ct. of App. 1975).

[185]Beaulieu v. Elliot, 434 P.2d 665 (Alaska 1967); Reeves v. Louisiana & Ark. Ry., 304 So. 2d 370 (La. Ct. of App. 1974); Missouri-Kan.-Tex. R.R. v. Miller, 486 P.2d 630 (Okla. 1971); Girard Trust Corn Exch. Bank v. Philadelphia Transp. Co., 410 Pa. 530, 190 A.2d 293 (1963); Oddo v. Cardi, 100 R.I. 578, 218 A.2d 373 (1966); Hardware Mut. Cas. Co. v. Harry Crow & Son, 6 Wis. 2d 396, 94 N.W.2d 577 (1959).

[186]*See, e.g.*, Ahterley v. MacDonald, Young & Nelson, Inc., 142 Cal. App. 575, 298 P.2d 700 (1956); Ploud v. Southern Pac., 266 Or. 666, 513 P.2d 1140 (1973); Crum v. Ward, 146 W. Va. 421, 122 S.E.2d 18 (1961); Behringer v. State Farm Mut. Ins. Co., 6 Wis. 2d 595, 95 N.W.2d 249 (1959).

[187]These decisions have used basically the same rationale as those federal decisions refusing such instructions. *See, e.g.*, Polster v. Girff's of America, Inc., 82 Colo. App. 264, 514 P.2d 80 (1973), *rev'd on other grounds*, 184 Colo. 418, 520 P.2d 745 (1974); Davis v. Fortuno & Jackson Chevrolet Co., 32 Colo. App. 222, 510 P.2d 1376 (1973); Kawanato v. Yesutake, 49 Haw. 42, 410 P.2d 976 (1966); Louisville & Nash. R.R. v. Mattingly, 318 S.W.2d 844 (Ky. Ct. App. 1958), *modified on other grounds*, 339 S.W.2d 155 (Ky. Ct. App. 1960); Bracy v. Great N. Ry., 136 Mont. 65, 343 P.2d 848 (1959), *cert. denied*, 361 U.S. 949 (1960); Chicago, Rock I. & Pac. R.R. v. Kinsey, 372 P.2d 863 (Okla. 1962); Crecelius v. Gamble-Skozmo, 144 Neb. 394, 13 N.W.2d 627 (1944); Scalise v. Central R.R., 129 N.J. Super. 303, 323 A.2d 525 (1974); Stallcup v. Taylor, 62 Tenn. App. 407, 463 S.W.2d 416 (1971); Dixie Feed & Seed Co. v. Byrd, 52 Tenn. App. 619, 376 S.W.2d 745, *cert. denied*, 379 U.S. 878 (1964); Texas Consol. Trans. v. Eubanks, 340

III. Summary

A. Inflationary & Productivity Factors

Unfortunately for attorneys practicing law in Indiana, neither jurisdiction they would be most concerned with, the Indiana Supreme Court nor the Seventh Circuit, has ever directly considered the admissibility of expert testimony on the effects of increased productivity and inflationary trends on the computation of lost future earnings. However, there are several Indiana cases indicating that such evidence is admissible. While most of the Federal Courts have addressed the issues, no general agreement has been reached. The First, Second and Fifth Circuits have taken the clearest stance against the use of such evidence, noting that it is far too speculative to be considered. Furthermore, the courts suggest that any undercompensation that might appear to result from the failure to consider the effects of inflation is offset by the concurrent increase in interest rates paid on investments and the refusal by most courts to allow a deduction of probable future income taxes from any award. However, even among these three circuits, there have been indications that the courts will allow evidence as to increased productivity to be admitted, provided a strict foundation is first laid to insure the reliability of such evidence.

Another approach, adopted by the Sixth and Eighth Circuits, rejects the notion that specific evidence as to inflationary trends should be received and considered but permits introduction of evidence on productivity increases, such as probable future raises in income or promotions. While holding evidence of future inflationary trends too speculative to be admissible, both circuits allow inflation to be taken into account by allowing the jury to consider diminished or increased purchasing power of the dollar. This approach appears to be an attempt by the circuits to avoid the use of expert witnesses to develop inflated awards.

A third approach is that followed by the Ninth and Tenth Circuits. These circuits allow evidence of both future inflationary trends and possible increases in productivity to be considered in determining lost future earnings based on the rationale that dealing with inflationary trends is the best way to insure a fairer and more accurate result. However, both circuits have added the caveat that they were not authorizing any arbitrary guesswork in determining inflationary effects and that a strict foundation should be laid before such evidence is permitted. While the Third Circuit originally re-

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S.W.2d 830 (Tex. Ct. App. 1960); John F. Buckner & Sons v. Allen, 289 S.W.2d 387 (Tex. Ct. App. 1956); Missouri-Kan.-Tex. R.R. v. McFerrin, 156 Tex. 69, 291 S.W.2d 931 (1956).

jected the introduction of such evidence as being too speculative, recent decisions have indicated a modification of its original position towards the approach taken by the Ninth and Tenth Circuits. Likewise, a district court of the Fourth Circuit has rendered a recent decision that if followed by the court of appeals in the Fourth Circuit would indicate the adoption of a position similar to that of the Ninth and Tenth Circuits.

The majority of the state courts that have addressed the issue have allowed such evidence. This would appear to be the current trend. The state courts, like the federal courts allowing such evidence, do so on the rationale that other factors equally speculative are already considered in determining damages, and that to ignore inflationary trends and evidence of increased productivity would lead to undercompensating the injured party. These courts also indicate that to exclude such evidence is to avoid economic reality and to indulge in the equally questionable presumption that inflation will not occur. However, decisions advocating the admission of such evidence require a strict foundation to insure the trustworthiness of the evidence.

The state courts excluding such testimony also follow basically the rationale of the federal courts, emphasizing the lack of consensus among economists and the basic unreliability of the science of economics in its efforts to accurately forecast economic conditions. State courts also express concern that allowing consideration of such factors will open the door to what they consider other collateral issues that would impair the proper functioning of the jury. Specifically, the courts note such additional evidence on factors such as taxes, deflation, and attorney fees would have to be allowed if evidence of inflation and productivity factors were to be considered. As a result, the jury would be caught in a quagmire of conflicting expert testimony and would lose sight of the main issues of the case. Finally, most courts also note that any apparent undercompensation is offset by the fact that a plaintiff receiving a large sum of money may invest the money in a manner that will give him some protection against inflation.

Thus, while there is an even split between federal courts allowing consideration of inflationary and productivity factors and courts not permitting evidence of such factors, the more recent federal decisions and the vast majority of state courts favor admissibility. However, even these courts have indicated reluctance to allow testimony that is based on unrealistically short time periods or uniquely inflationary periods. The courts have also been reticent to allow projections too far into the future because long term predictions of continued inflation lead to excessively high verdicts. In essence, such long term projections predict economic doom, since no

economy can function on a continued inflationary spiral. While the courts have reacted more favorably towards admission of evidence concerning increased productivity than evidence of inflationary trends, they still require a strict foundation to be laid, generally consisting of the particular individual's past wage increases. In the absence of such evidence, the courts require evidence of wage increases of an individual in as similar a position to the injured party as possible.

B. *Income Taxes*

1. *Evidence of Tax Impact.*—Indiana is among the majority of states that have held that inquiries at trial into the incidents of taxation in damage suits would be too conjectural and confusing and would inject collateral issues into the trial. However, the issue has only been discussed where a party has merely requested a cautionary instruction to the effect that the award is non-taxable. The issue of the admissibility of evidence of the impact of income taxation on the award is entirely distinct from the question of the propriety of a cautionary instruction. Although the Indiana Supreme Court has failed to make this distinction, it has been acknowledged by the Indiana Court of Appeals. Only four states, Connecticut, New Jersey, Iowa and New Mexico, have held evidence of future tax impact should be considered, relying on the basic rationale that such evidence is no more speculative than other factors used to compute lost future earnings and that to do otherwise would lead to overcompensation of the plaintiff.

Only one state has adopted the *McWeeney* Rule permitting the jury to consider income taxes only in those cases where taxes will have a significant and substantial effect in the computation of probable future earnings. However, among the federal courts, the *McWeeney* Rule has clearly become the majority rule. It has been adopted by the Second, Fourth, Fifth, Sixth, Seventh and Ninth Circuits. While the Fourth Circuit and the D. C. Circuit require the impact of taxes to be considered in wrongful death actions, no federal court has even held that evidence of the projected effect of taxes on plaintiff's damages is always admissible, although there is dicta in a Ninth Circuit decision that evidence of the impact of taxation should be considered in all cases.

The *McWeeney* Court advanced the following propositions in support of its decision: (1) The determination of future tax liability would be too conjectural in light of factors such as changes in the family status of the injured party in years to come, possible changes in the exemption and deduction provisions of the tax law, possible changes in the rates of taxation, and so forth; (2) The use of a net income theory would be too complex and confusing for the jury; (3)

Other factors such as inflation and attorney fees tend to counterbalance any resulting overcompensation.

These propositions have come under sharp attack in dissenting opinions and legal commentaries. In response to the objection that such a determination would be too conjectural, it is generally noted that evidence of the impact of income taxes on future earnings is no more speculative than other factors used to compute damages. In fact, the existence of income tax in this country is less conjectural than the continuance of the plaintiff's salary during the same period. The argument for the first proposition loses much of its force when a court is willing to consider the equally if not more speculative factors of inflation and productivity. Even those federal circuits holding such evidence to be too speculative have acknowledged that when state law requires the effect of inflation to be considered one must in all fairness allow evidence of the impact of income taxes to be considered.

It is difficult to accept the second assertion made by the *McWeeney* Court that the tax issue is beyond the understanding of the layman when it is realized that the average American is exposed to tax computations and considerations in his everyday life and would thus appear to be qualified to assess such problems at trial. Finally, the argument that consideration of taxes would lead to the necessity of considering attorney's fees is discredited when one realizes that unlike taxation, which undoubtedly would have occurred whether or not the party had been injured, the impact of attorney's fees has no relation to the jury's task of estimating what the individual's future earnings would have been. Also, attorney's fees are the result of private contract between the litigant and attorneys and are thus irrelevant to the issue of just compensation.

Of the circuits not adopting the *McWeeney* Rule, the Tenth Circuit has taken the position that the admissibility of such evidence is totally within the trial court's discretion. Only the First, Third, and Eighth Circuits hold all evidence of income tax impact inadmissible, based on such various rationales as Congressional intent, collateral source doctrine or that such evidence is too speculative. However, even these courts acknowledge that when the plaintiff receives his gross earnings he is being overcompensated. One decision from the Ninth Circuit went so far as to hold in an FTCA case that failure to consider taxes was the equivalent of awarding punitive damages, which is impermissible under the FTCA.[188]

2. *Cautionary Instruction on Taxes.*—Many courts, especially the state courts, including Indiana, have refused to give a cautionary instruction because they have confused the problem of the

[188]Felder v. United States, 543 F.2d 657 (9th Cir. 1976).

cautionary instruction with the problem of whether the evidence of the incidence of taxation should be admitted during trial. Once these issues are confused, the court points out how "confused" the jury would be with this additional information. The fallacy of these arguments is that the requested instruction does not relate to the impact of taxation on plaintiff's future wages and requires no complex calculations. It concerns only the effect of the tax laws on plaintiff's award. The purpose of such a cautionary instruction is merely to dispel any misconceptions that the jurors might hold on this question. A recent Indiana Court of Appeals decision has recognized this distinction that eluded the Indiana Supreme Court.

In contrast to the clear majority following the *McWeeney* Rule on the evidentiary issue, the federal courts that have considered whether a form of a cautionary instruction should be given have not ruled uniformly. Three circuits, the Second, Sixth, and Tenth, have held that the decision to give such an instruction is within the trial court's discretion. Therefore, it will not be reversible error either to refuse such an instruction, or to give such an instruction. The First Circuit, while holding the refusal to give such an instruction was not error, indicated that if there was evidence that the jury was improperly considering taxes it would be error not to give the instruction. The Eighth Circuit has specifically refused to rule on the question. The Fifth Circuit flatly rejects the propriety of a cautionary instruction. The Third and Ninth Circuits have held that such an instruction must be given in future cases. The Third and Ninth Circuit holdings are also supported by the majority of commentators who have considered the question. However, the majority of states addressing the issue have held such an instruction should not be given.

The better rationale used in those federal and state cases that disapprove of the use of the instruction is that it cannot be assumed that the jury will not follow instructions when it has been correctly instructed on the measure of damages. Since there is a possibility of harming the plaintiff by allowing such an instruction, it is better to instruct the jury on the proper measure of damages and then rely on the presumption that it will follow the instruction. The counterargument is that, given the general tax awareness of the average citizen and the fact that few persons actually know of the special exclusion for personal injury awards, failure to give such an instruction could result in the plaintiff receiving an enhanced award based on the probable misconception that the amount awarded by the jury will be reduced up to fifty percent by taxes.

C. *Conclusion*

The Indiana courts at the present apparently give the plaintiff's attorney the worst of both worlds, indicating indirectly that

economic trends may be considered but projections of future tax liability or cautionary instructions may not. Although many courts have done so, it is theoretically inconsistent to admit evidence of any one of the factors (that is inflationary/productivity evidence as opposed to tax impact evidence) without admitting evidence of the other. The objective of the basic system of damages in this country is to place the injured party in the same position, as nearly as can be done with a monetary award, as he or she would have been had the wrong not occurred. Since inflationary/productivity factors and taxes would both theoretically affect the injured party's position, it is inconsistent to admit evidence of one and not the other.

However, it may be more practical to admit evidence of tax impact evidence than inflationary/productivity evidence. Tax factors are less speculative than inflationary and productivity factors. It is more probable that taxes will continue at present rates than inflation, if only for the reason that no economy can continue to exist with constantly spiraling inflation. Furthermore, while taxes are generally a certainty of life that the plaintiff would have had to bear, the plaintiff and defendant must equally share the risk of inflationary and depressionary periods. Finally, any undercompensation due to inflation will be partially offset by realization of a higher interest rate than that used in discounting the award to present value. Nevertheless, the tendency of several courts in the past, including those in Indiana, has been to allow evidence of inflation and productivity and to exclude evidence of the impact of income taxes, a position which appears to be wholly untenable.

Perhaps the *McWeeney* Rule is the best approach to the tax issue, although the courts have been vague in setting out the rationale that underlies the rule. Some courts question the relevancy of such evidence. These courts are actually confusing relevancy with countervailing factors such as danger of confusion, collateral issues, or delay that may outweigh the probative value of such evidence. To say such evidence is not "relevant" or "pertinent" is to ignore the basic guide of tort law, which is to compensate the plaintiff for what he has lost. Although the *McWeeney* Rule has seldom been analyzed as such, it could be considered as an evidentiary rule, weighing probative value against probative danger. When admittedly relevant evidence has, on balance, a greater tendency to frustrate rather than to promote the ultimate end of just compensation, the trial court must exercise its discretion and refuse to admit it. Thus, at the lower and middle income levels, where the probative value of such evidence is less and the probative dangers greater, such evidence is often not allowed, while at the higher income brackets and consequently higher tax rates, the probative value increases sufficiently to outweigh any probative dangers.

Finally, as to the propriety of a cautionary instruction, the benefits of informing the jury of the actual consequences appear so obvious, and the burden in terms of confusion so minimal, that the argument for giving such an instruction is clearly the better position.

Inflation, productivity, and taxes do affect future earnings and should be considered if the injured party is to be adequately compensated. Furthermore, today's juror is likely to consider such factors regardless of whether evidence is presented on these issues and regardless of the lack of instructions. Therefore, it should be the court's duty to insure that the jury has competent evidence on which to base such predictions by requiring a strict foundation to be laid to assure the evidence is as reliable as possible.

EDWIN B. WAINSCOTT

When the Product Ticks: Products Liability and Statutes of Limitations

I. Introduction

Have you heard of the wonderful one-hoss shay,
That was built in such a logical way
It ran a hundred years to a day,
And then, of a sudden, it ____ . . . .[1]

In this delightful poem, "The Deacon's Masterpiece," by the senior Oliver Wendell Holmes, the deacon, preparing to build a type of carriage known as a chaise, observed that long-lived products such as carriages tend to break down long before they ultimately wear out. He determined to avoid the inconvenience and danger of unexpected component failures by first ascertaining the chaise's most vulnerable part, designing that part to last almost indefinitely, and then fashioning every other component and assembly to last as long as it. Built to these simple but logical guidelines, the "one-hoss shay" functioned without breaking down for exactly one hundred years, whereupon each part of each assembly wore out —simultaneously—and the carriage self-destructed into sawdust.

Unfortunately, the amazing skill of Holmes' deacon, like that of Senor Stradivari, is now lost to us. Today's products, if they survive the tyranny of current fashion and economic obsolescence, eventually require ever more frequent repairs until they are declared "worn out" in a somewhat arbitrary decision. Even a product designer cannot accurately predict any specific unit's ultimate moment of uselessness. However, until the product is scrapped, in almost all jurisdictions, the manufacturer remains liable to users, perhaps even to bystanders, for injuries to person or property which result from unreasonably dangerous defects in the design or manufacture of the product or in the warning and instruction system of the product or its package. The product may have been altered, processed, or misused, but if a defect existed at the time of sale and the defective condition was either the sole or a substantial concurring cause of the injury, the manufacturer may nevertheless be held liable.[2]

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[1]O.W. Holmes, *The Deacon's Masterpiece: or, The Wonderful "One-Hoss Shay"*, in Complete Poetical Works of Oliver Wendell Holmes 158 (Cambridge Ed. 1914) (written by the father of the renowned Supreme Court Chief Justice in 1858).

[2]The great majority of American jurisdictions apply the doctrine of strict tort liability, as defined by Restatement (Second) of Torts, § 402A (1965), to cases in which plaintiff or his property is injured by a defective product. This Note will not attempt to discuss the wide variation of existing judicial interpretation of this section as it is applied to definitions of the essential elements of defect and causation, parties covered by the doctrine, or extent of plaintiff's contributory conduct necessary to raise an effective defense.

Thus, in the case of long-lived products, such as machine tools, the manufacturer's exposure to liability may theoretically continue indefinitely after the introduction of the product into the stream of commerce. This potentially long time gap from manufacturer's (defendant's) act to user's (plaintiff's) injury creates a unique situation in tort law, since the usual tort case finds plaintiff injured as the direct and *immediate* result of defendant's action.

Problems posed by manufacturers' open-ended exposure to liability from long-lived defective products have led to proposals limiting that liability. Various legislation has been enacted or proposed in more than one-half the state legislatures[3] and in the United States Congress[4] to relieve product manufacturers of liability after a certain period of time, commencing when the product is either manufactured, first sold, or first used for its intended purpose. Statutes which run from the time of the defendant's act have been characterized as repose statutes, to be distinguished from statutes of limitations in general.[5] The unique feature of these legislative schemes is that they purport to cut off liability without regard to when plaintiff's cause of action accrues. Under such statutes, a product user, such as a machine operator in a factory, may find himself time-barred before he is injured—perhaps even before working on the defective machine for the first time.

Laws which would bar an action before the cause of action accrues are justifiable only in response to an urgent social need. Proponents of such legislation vigorously claim that such a problem exists and that, indeed, it has become a "crisis." This Note will examine the evidence supporting that view, consider the doctrinal questions raised by the legislative proposals, attempt to project the effects which can be anticipated if the legislation is generally adopted, and investigate alternative solutions to the problem.

II. Is There a "Crisis"? Is There a Problem?

Manufacturers, wholesalers, and liability insurers claim that the

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[3]"At this writing, 73 product liability bills have been either prepared or introduced by the legislatures of 28 states." Irving, *Our National Product Liability Crisis and Why You are Part of it*, Iron Age, August 1, 1977, at 113. Since a number of these bills have been drafted or adopted by interested national organizations, such as the American Mutual Insurance Alliance, it can be assumed that these proposed statutes have been widely lobbied for in state legislatures.

[4]*See, e.g.*, S. 403, 95th Cong., 1st Sess. (1977), *reprinted in Product Liability Insurance: Hearings on S. 403 Before the Sub-Comm. for Consumers of the Senate Comm. on Commerce, Science and Transportation*, 95th Cong., 1st Sess. 3 (1977) [hereinafter cited as *S. 403 Hearings*]; S. 1706, 95th Cong., 1st Sess., 123 Cong. Rec. S10029 (daily ed. June 16, 1977). *See* discussion of these two bills in text accompanying notes 105-114 *infra*.

[5]*See* text accompanying note 139 *infra*.

rapid increase in numbers of products liability suits, as well as the size of awards and settlements, justify the fact that products liability insurance premiums have skyrocketed and that such insurance is virtually unavailable to a significant number of product sellers. They also predict that these problems will continue to worsen, leading to inadequately covered sellers, insufficiently protected users, business failures, and higher product prices.[6]

No one disputes the mere fact that claims and premiums are increasing,[7] but controversies exist as to the rate of increase, the validity of trend projection, the causes of the increased litigation, and the implications for the economy. A number of companies in certain industries have been severely affected by the explosion in insurance premium rates and scarcity of insurance coverage. In response, the President's Economic Policy Board has established an Interagency Task Force under the Department of Commerce to study "the impact of product liability claims on the economy."[8] The Interagency Task Force subsequently reported that betwen 1974 and 1976, product liability insurance premiums rose "substantially in most target industries" but affected certain industries and small business firms more seriously, and that insurance coverage remained generally available, although perhaps unaffordable. The Task Force also reported that a number of companies have decided to go "bare" (uninsured), although some companies may have insufficient resources to meet substantial products liability judgments.[9] The In-

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[6]Representatives of seller and liability-insurer groups have testified vigorously in support of this proposition before legislative committees on federal and state levels. For an extensive collection of such testimony with considerable statistical documentation, *see S. 403 Hearings*, *supra* note 4. Note in particular the statements of Charles W. Steward (president, Machinery & Allied Products Institute), *id.* at 138; Peter, A.R. Findlay (executive vice president, American Die Casting Institute, Inc.), *id.* at 129; James D. McKevitt (counsel, National Federation of Independent Business), *id.* at 100; Paul Benke (vice president, AMF Marine Products Group), *id.* at 94; William C. McCamant (executive vice president, National Association of Wholesaler-Distributors), *id.* at 120; Stan Haransky (vice president, Truck Body & Equipment Association, Inc.), *id.* at 422; National Machine Tool Builder's Association, *id.* at 445. For similar testimony on a state level, *see* Minutes of the Select Joint Committee on Products Liability, 1977 Indiana Legislature (July 25, 1977; August 24, 1977) [hereinafter cited as *Joint Committee*] (minutes available from the Indiana Legislative Council). *See also* Machinery and Allied Products Institute, Products Liability: A MAPI Survey (Aug. 1976) [hereinafter cited as MAPI Survey] (available from MAPI, 1200 Eighteenth Street N.W., Washington, D.C. 20036).

[7]U.S. Dep't of Commerce, Interagency Task Force on Product Liability Briefing Report ii (1977) [hereinafter cited as Briefing Report].

[8]*Id.* at i. This Note will not examine the statistical data presented by this study, beyond testing the proposition that a serious and widespread economic problem exists or is likely to develop soon as a result of increased products liability costs.

[9]*Id.* at ii.

teragency Task Force Briefing Report noted that this increased exposure to liability has resulted in fewer manufacturers' decisions in favor of marketing new products[10] and greater manufacturers' allocation of resources to product safety systems.[11]

The Task Force found that "[t]he rate of increase in product liability claims appears to have been rising in excess of the rate of increase in actual product injuries."[12] This finding could have been predicted from a 1970 study by the National Commission on Product Safety in which researchers sought to determine "the extent to which injured consumers resort to legal remedies."[13] In this study of 276 respondents injured by household products, only 4% contacted an attorney, and an additional 10.3% took the matter up with an insurance company. Those who decided against seeking relief typically reported that they thought they had no case because they (or someone they would not sue, such as a close relative) in some way contributed to the accident.[14] It seems reasonable to conclude that a substantial portion of the 85.7% who failed to seek damages had valid claims against product manufacturers. Although the doctrine of strict liability has been accepted by the courts so rapidly that public awareness of plaintiffs' rights has lagged behind their creation, it was reasonably predictable that increasing numbers of injured persons would eventually discover those rights. Emerging public discovery of the right to relief because of injury from a defective product, despite contributory negligence on the part of the plaintiff, has resulted in a "transitional period" characterized by a "psychology of entitlement."[15] The eventual maturation of this discovery process should result in an equilibrium between frequency of claims and frequency of accidents.

The growth rate in products liability claims and in the amount of award or settlement are vigorously debated statistics, because

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[10]*Id. See* text accompanying note 118 *infra.*

[11]BRIEFING REPORT, *supra* note 7, at ii.

[12]*Id.*

[13]NATIONAL COMMISSION ON PRODUCT SAFETY, PRODUCT SAFETY LAW AND AMINISTRATION: FEDERAL, STATE, LOCAL AND COMMON LAW, SUPPLEMENTAL STUDIES, *Claims and Recovery for Product Injury Under the Common Law* 237 (1970).

[14]*Id.* at 242.

[15]Boe, *Ills of Society Seen as Rooted in Society in Transition Period, reprinted in part in* NATIONAL UNDERWRITER, May 7, 1976, at 1 (talk before the New York chapter of the Chartered Property Casualty Underwriters). Archie R. Boe, chairman of Allstate Insurance Company, suggests that the rapid creation of wasteful and duplicative compensation systems is a judicial response to soaring consumer expectations. He anticipates that a resolution of these expectations with economic realities will require a fifteen-year transitional period in which new values underpinning the liability insurance system will have to be developed. Mr. Boe appears to favor a reaffirmation of, and return to, fault principles.

available data are fragmentary.[16] The Insurance Information Institute, an organization which assembles data for the insurance industry, noted in 1976 that a recent Department of Commerce report cited an "estimate" which showed average losses per claim to have increased 686% from 1965 to 1973, while the general price index rose 41% during the same period.[17] The Institute reported that a study of insurance policies written exclusively for *products* liability showed that between 1969 and 1973, the number of claims increased 26% and the loss per claim rose 202%.[18] The Institute also noted that the judgment docket of Cook County, Illinois, showed a 30.9% increase of product claims in the 1975-76 term over the preceding term, with an increase in average verdict from $109,502 to $175,947—a 61% increase.[19]

On the other hand, Robert G. Begam, president of the Association of Trial Lawyers of America, compared awards in twenty-two product-related death cases from 1973 with nineteen such cases in 1975 and found that average damages of about $300,000 per case were awarded in both groups. All plaintiffs in this study were wage earners.[20] Begam submitted this highly limited study to refute the claim of "explosion" in the size of jury verdicts, declaring that the burden of proving a crisis rests with the insurance industry.[21]

Many of the assertions regarding claim experience, whether made by supporters of legislative change or by those who advocate maintenance of the status quo, have rested on very limited data. The Interagency Task Force Briefing Report noted that generalizations based on surveys financed or organized by its contractors, such as telephone surveys and trade association surveys, may be of limited validity because of their narrow scope, spotty response, and inadequate sampling techniques.[22] The Briefing Report noted the

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[16]As noted, no consensus exists as to the rate of increase in frequency of claims or size of awards, and sufficient data is not available at this time to make an authoritative determination. This Note accepts the qualified findings of the Interagency Task Force on Product Liability that the *claims* increase rate exceeds the *accident* increase rate and that total dollars of pending claims have increased substantially in the target industries. BRIEFING REPORT, *supra* note 7, at 7. It is further assumed that the increase in insurance premiums can, in good part, be justified by this increased claim experience. *See* note 28 *infra*.

[17]Insurance Information Institute, Product Liability, The Gathering Storm 9 (December 1976) [hereinafter cited as Gathering Storm] (background memorandum obtainable from the Insurance Information Institute, 110 William Street, New York, New York 10038).

[18]*Id.* at 10.

[19]*Id.*

[20]Begam, *One More Insurance 'Crisis,'* TRIAL MAGAZINE, November 1976, at 46, 49.

[21]*Id.* at 49.

[22]BRIEFING REPORT, *supra* note 7, at 5-6.

need for a broad closed-claim survey[23] and a scientifically conducted survey of manufacturers.[24] Until data can be developed which authoritatively quantify the rate of increase in the frequency and severity of products liability costs over the economy as a whole, the dimensions of the products liability problem will remain undelineated.

One cannot deny, however, that products liability insurance *premiums* have risen dramatically in recent years.[25] Since premiums are based not only on past experience but also on future estimates, insurance underwriters can produce short-run percentage changes which may not appear to be directly linked to current or past experience.[26] Recent testimony by Indiana manufacturers before a joint legislative study committee included numerous instances where premiums escalated several thousand percent, but were apparently unjustified by past losses on the part of the insured companies.[27] For the most part, this testimony was from small- to

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[23]A broad closed-claim survey such as is now available from the Insurance Services Office (ISO), *see* note 153 *infra*, will provide information as to the *nature* of judgments but "will not show liability judgment trends." BRIEFING REPORT, *supra* note 7, at 6.

[24]A broad survey of manufacturers as to claim frequency and judgment experience—a most formidable project—has not yet been produced. For future analyses, a mechanism which would report judgments from both lower and appellate court records might be more practical, although such records would omit considerable settlement data. The Interagency Task Force did rely on such records from Connecticut, "the only state that has kept track of that information," BRIEFING REPORT, *supra* note 7, at 5.

A limited manufacturers' survey of claim experience is attempted as part of the MAPI Survey, *supra* note 6, at 7-12. The findings are highly qualified but they do tend to support a conclusion of an increase in the judgment per claim rate in the machinery industry.

[25]*See* note 6 *supra* and accompanying text.

[26]Representatives of the plaintiff's bar have suggested that liability insurance premium increases may be due in good part to investment losses by insurance companies. *See, e.g., S. 403 Hearings, supra* note 4, at 73 (statement of Craig Spangenberg, chairman, National Affairs Committee, The Association of Trial Lawyers of America).

For an excellent technical summary of the liability rate-making process and the effect of the recent adverse claim experience on that process, *see S. 403 Hearings, supra* note 4, at 202 (statement of Mavis A. Walters, vice president, Government and Industry Relations, Insurance Services Office). Note that neither investment income nor loss plays a part in the actuarial computations. In testimony before the Select Joint Committee on Products Liability of the Indiana Legislature, Ms. Walters is reported to have said that "ISO does not monitor adherence to its recommendations." *Joint Committee, supra* note 6, at 1 (September 19, 1977). But Ms. Walters does suggest that the recent substantial premium increases could be justified by the generally adverse claim experience of the early 1970's. *Id.* at 13 (statement by Ms. Walters).

[27]*Joint Committee, supra* note 6, (October 14, 1977) (statement by Brian J. Krenzke, Indiana Manufacturers Association). This IMA report surveys the claim and premium experience from 176 Indiana manufacturers. Although untabulated, the raw

medium-sized firms in what could be characterized as medium-risk industries, such as manufacturers of special-purpose machine tools, pressure tanks, and electronic components. The testimony indicated that many other similarly situated manufacturers, as well as businesses in the chain of product distribution, were experiencing similar rapid and substantial premium increases.[28]

Nevertheless, an increase of tenfold or more over a period of a few years is not the majority experience, even within these relatively "risky" industries. The Machinery and Allied Products Institute (MAPI) Products Liability Survey showed that 30% of its respondents incurred less than a doubling of premium cost over the preceding five-year period, and another 58% reported increases of less than tenfold (1000%).[29] Perhaps more significantly, 86% of respondents in the MAPI Survey reported that their 1976 products liability insurance premiums represented less than 1% of sales.[30]

Unquestionably, many of these premium increases have been very steep and have become intolerable for certain businesses. Costs that leap substantially ahead of the rate of inflation may properly be considered a serious problem. However, the situation will be something less than an immediate general crisis, if the cost explosion proves to be temporary, if it is essentially confined to a minority of business units of modest business volume, and if total premium costs for the industries most affected remain in the neighborhood of 1% of sales.

The Interagency Task Force Briefing Report concluded:

> Nevertheless, our study does suggest that the so-called product liability "crisis" is not a crisis in the sense that a large sector of industry cannot obtain product liability insurance or that the increased cost of such insurance has made a substantial impact on the price of many products. On the other hand it does seem clear that a number of smaller businesses are facing a difficult choice. . . .[31]

Recognizing that "government action need not always spring from crisis,"[32] the Briefing Report then considered a spectrum of options which are directed toward *averting* a crisis.

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data appear to support the proposition that product liability insurance *premium increase* in Indiana is greatly in excess of product liability *claim loss* for those manufacturers reporting.

[28] *Joint Committee*, *supra* note 6, (July 25 & Aug. 24, 1977).

[29] MAPI Survey, *supra* note 6, at 24.

[30] *Id.* at 23.

[31] BRIEFING REPORT, *supra* note 7, at 40.

[32] *Id.*

III. Dealing with the Products Liability Problem—In General

Three primary lines of attack have been suggested to deal with the costs, burdens, and inequities allegedly incurred by sellers with regard to products liability exposure. The first approach is simply to seek ways in which to manufacture and sell safer products while concurrently training, instructing, and supervising product users more effectively. The second is to study the insurance delivery system in order to determine whether it can be modified or supplemented to spread risks more equitably. The third approach is to enact legislation modifying the tort litigation system in order to correct the alleged imbalance which now purportedly gives the plaintiff an unfair advantage.

Legislative proposals to change tort law[33] by limiting or inhibiting the claims or recoveries of certain injured product users include statutory recognition of a misuse defense[34] and the barring of a plaintiff's recovery whenever the product is substantially modified after sale and the modification is a substantial factor in causing the accident.[35] These proposals generally make no provision for finding liability when the defendant might have foreseen the misuse or the later modification but nevertheless failed to guard or warn.

Other proposals would bar recovery when the safety device which might have prevented the injury was not in the "state of the art," either at time of sale or at the time the design was prepared,[36] and would bar evidence of post design or post manufacture modification or advance in safety technology.[37] It has also been proposed that the collateral source rule be abolished so that a plaintiff

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[33]Many of the proposed tort "reform" statutes drafted or adopted by national organizations have been collected in a memorandum prepared by the Independent Insurance Agents of America, Inc. (IIAA). This memorandum is reprinted in *Product Liability Insurance: Hearings on S. 403 Before the Sub-Comm. for Consumers of the Senate Comm. on Commerce, Science and Transportation*, 95th Cong., 1st Sess. 457-99 (1977). This Note will cite to the reprinted memorandum for examples of proposed tort modification as, *e.g.*, Kansas Bill 852, *reprinted in part in S. 403 Hearings*, IIAA Memorandum, *supra* note 33, at 478 [hereinafter cited as Kansas Bill 852].

[34]*See, e.g.*, the product liability statute proposed by the Independent Insurance Agents of Massachusetts (IIAM), *reprinted in part in S. 403 Hearings*, IIAA Memorandum, *supra* note 33, at 478 [hereinafter cited as IIAM Statute]. *See also* Gathering Storm, *supra* note 17, at 17.

[35]*See, e.g.*, Kansas Bill 852, *supra* note 33, at 478; Defense Research Institute, Sample Statute, *reprinted in part in S. 403 Hearings*, IIAA Memorandum, *supra* note 33, at 477 [hereinafter cited as DRI Statute].

[36]*See, e.g.*, IIAM Statute, *supra* note 34, at 475 ("at the time the manufacturer . . . parted with possession and control or sold it, whichever occurred last"); Kansas Bill 852, *supra* note 33, at 476 ("at the time such plan or design was prepared").

[37]*See, e.g.*, DRI Statute, *supra* note 35; Kansas Bill 852, *supra* note 33, at 476.

who initially recovers from his own insurance carrier will not be allowed to collect a second time from defendant, although this proposal has been criticized because defendant would thereby benefit from the plaintiff's prudence in insuring himself.[38]

It has also been suggested that size of awards be limited;[39] non-economic awards, such as damages for pain and suffering, be limited or eliminated;[40] punitive damages be barred;[41] and contingency fees more strictly regulated.[42] Provisions have also been advanced calling for installment payment of damages,[43] payment of defendants' costs of litigation by unsuccessful plaintiffs,[44] and the elimination of the ad-damnum clause from the complaint.[45] Other proposed legislation would restrict the remedy for workplace accidents to worker's compensation,[46] apply comparative fault principles to damage awards in product cases,[47] substitute arbitration for tort litigation,[48] and provide that compliance with government standards shall be a defense.[49] Finally, virtually all proposed products liability tort reform bills include a statute of limitation or repose which would run from the date on which the product is introduced into the stream of commerce.[50]

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[38]*See, e.g.*, DRI Statute, *supra* note 35, at 488; Kansas Bill 852, *supra* note 33, at 488.

[39]*See* Indiana Medical Malpractice Act, § 2(a), IND. CODE § 16-9.5-2-2 (1976).

[40]*See, e.g.*, American Mutual Insurance Alliance Proposed Statute, *reprinted in part in S. 403 Hearings*, IIAA Memorandum, *supra* note 33, at 469 [hereinafter cited as AMIA Statute] (would limit pain and suffering to two times special damages); Kansas Bill 852, *supra* note 33, at 469 (would place this limit at 30% of special damages).

[41]*See, e.g.*, AMIA Statute, *supra* note 40, at 466; DRI Statute, *supra* note 35, at 481.

[42]*See, e.g.*, American Insurance Association Proposed Statute, *reprinted in part in S. 403 Hearings*, IIAA Memorandum, *supra* note 33, at 487 [hereinafter cited as AIA Statute].

[43]*See, e.g.*, Kansas Bill 852, *supra* note 33, at 488.

[44]*See, e.g.*, Gathering Storm, *supra* note 17, at 17.

[45]*See, e.g.*, DRI Statute, *supra* note 35, at 489; AMIA Statute, *supra* note 39, at 488.

[46]*See, e.g.*, AMIA Statute, *supra* note 40, at 483; O'Connell, First Party No-Fault Coverages as a Sole Remedy to Solve Many Tort Liability Problems (1977) (statement printed and distributed by Marsh & McLennan, Inc., 200 Clarendon Street, Boston, Mass. 02116) [hereinafter cited as Sole Remedy].

[47]*See, e.g.*, DRI Statute, *supra* note 35, at 489.

[48]*See, e.g.*, S. 403, 95th Cong., 1st Sess. §§ 401-405, 501-510 (1977), *reprinted in S. 403 Hearings*, *supra* note 4, at 3. *See also* Gathering Storm, *supra* note 17, at 17.

[49]*See, e.g.*, Kansas Bill 852, *supra* note 33, at 485; AMIA Statute, *supra* note 40, at 485.

[50]Proposed legislation has variously defined the date on which a product is introduced into the stream of commerce. *See, e.g.*, AMIA Statute, *supra* note 40, at 472 ("No action . . . may be commenced more than [x] years after the product was first sold . . . ."); DRI Statute, *supra* note 35, at 473 (Sample Statute II(2)) ("within a period of [x]

Each of these proposals suggest substantial modifications of existing doctrine and practice in most jurisdictions, although enactment of any one proposal would reduce the need for others. For example, limiting the size of awards would greatly affect attorneys' contingency fees, perhaps eliminating any necessity to consider interfering with the freedom of contract between lawyer and client.[51] Similarly, adopting a form of the English rule whereby the losing party pays the winner's litigation costs might prove to be sufficiently inhibiting so as to make other proposals less pressing. Thus, when considering the potential impact of any one proposal in this group, attention must be given to the overlap of impact if more than one of the proposed modifications were to be enacted at the same time. Although each proposal can be studied independently, the combined impact on claims and awards must be considered.

The following discussion will focus on one of the more radical proposals, a statute of limitations or repose which would run from date of defendant's final act—the introduction of the product into the stream of commerce—rather than from date of plaintiff's injury. Such a statute would certainly reduce products liability claims significantly.[52] If, however, certain defenses, such as "misuse," "later modification," or "state of the art,"—defenses which are less at odds with long-established legal doctrines—were codified, many of these same claims might be eliminated, thereby reducing the need to advocate the more radical repose doctrine.

IV. Statutes of Limitation—In General

"A statute of limitations is an act limiting the time within which an action shall be brought."[53] Although such a limitation did not exist at common law, the earliest statutes date back to Roman times.[54] The earliest English statute, dating from 1236, prohibited real property actions based on seisin occurring prior to a given date, such as

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years after it was put in use"); *id.* (Sample Statute III(1)) ("within [x] years after the date of the delivery of the completed product to its first purchaser"); AIA Statute, *supra* note 35, sec. 2, at 472, ("eight (8) years after the manufacturer of the final product parted with its possession and control, or sold it, whichever occurred last, except, where the defendant is a lessor, bailor or licensor of a product, . . . the action must be commenced no later than eight (8) years after the time at which the defendant ceases to have the use, possession or control of the product or ceases to be under the legal duty to inspect, maintain, repair, modify or improve it").

[51] *See* Indiana Medical Malpractice Act, § 2(a), Ind. Code § 16-9.5-2-2 (1976), which provides for $500,000 maximum recovery. Because this liability ceiling has been accompanied by other restrictive provisions, it is difficult to trace the recent lack of plaintiffs' success in malpractice suits to the liability ceiling alone. *See* note 64 *infra.*

[52] *See* text accompanying note 152 *infra.*

[53] 53 C.J.S. *Limitations of Actions* § 1, at 900 (1948).

[54] *See* R. Sohm, The Institutes: A Textbook of the History and System of

the coronation of a king.[55] As the given date receeded, the limitation naturally affected fewer actions, making the statute less effective. In 1540, the statute of 32 Henry 8 was enacted, establishing fixed-time periods.[56]

The modern law of limitations on personal actions dates from the Limitation Act of 1623, which established different periods for various types of actions.[57] In the United States, statutes in each state provide different time limits for recovery of land, oral and written contracts, injuries to person or property, and all other actions. There are also special statutes designed to deal with special situations, sometimes departing from traditional form, such as the Marketable Title Acts in which unrecorded property interests are shut off after a given number of years from the time of the conveyance in question.[58]

The purpose of statutes of limitation is to protect defendants and courts from stale and tenuous claims.[59]

> Statutes of this character have sometimes been said to be founded in part at least on the general experience of mankind that claims which are valid are not usually allowed to remain neglected, and that the lapse of years without any attempt to enforce a demand creates a presumption against its original validity or that it has ceased to exist, the negligence or laches of plaintiff being also advanced as an additional ground by some of the authorities.[60]

It would seem that defendant's right to raise a statute of limitations defense derives directly from plaintiff's failure to pursue his cause of action within a reasonable time after its accrual. This purpose of limitation statutes—the protection of court and defendant from stale claims[61]—comes into play only when plaintiff has failed to bring his suit in a timely manner.

ROMAN PRIVATE LAW 318-22 (3d ed. Ledlie's trans. 1907), *cited in Developments in the Law—Statutes of Limitations*, 63 HARV. L. REV. 1177, 1177 n.2 (1950).

[55]*See* 2 F. POLLOCK & F. MAITLAND, THE HISTORY OF ENGLISH LAW 81 (2d ed. 1898), *cited in Developments*, *supra* note 54, at 1177 n.3.

[56]*See* 32 Hen. 8, c. 2 (1540) (30-60 years from last seisin of claimant or ancestor), *cited in Developments*, *supra* note 54, at 1177 n.4.

[57]*See* Limitation Act, 1623, 21 Jac. 1, c. 16, *cited in Developments*, *supra* note 54, at 1177 n.5.

[58]*Developments*, *supra* note 54, at 1179.

[59]*Id.* at 1185.

[60]53 C.J.S. *Limitations of Actions* § 1, at 902 (1948).

[61]In states in which the purpose of limitations is held to be the exclusion of stale claims from state trial court forums, the statutes may be considered procedural for choice-of-law purposes. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 142 (1971). When,

"A cause or right of action accrues, so as to start the statute of limitations running, when the right to institute and maintain a suit arises, and not before."[62] Courts may rule that plaintiff had a cause of action before he discovered it and that the statute started running before plaintiff knew he was injured. This result can also be achieved by legislation, such as the Indiana Medical Malpractice Act, which runs the statute from the date of the medical procedure that allegedly resulted in harm to plaintiff,[63] although the plaintiff may not and perhaps could not have discovered the harm until much later.[64] Less harsh provisions would run the statute from date of discovery of harm or from the date when plaintiff *should* have reasonably discovered the harm.[65]

Limitations on breach-of-warranty actions may run from date of sale, on the contract theory that plaintiff is able, under the Uniform Commercial Code, to maintain an action for at least nominal damages upon tender of defective goods.[66] In most jurisdictions, a buyer or user[67] may include in his warranty action claims for personal injury or property damage. These latter claims are governed by the tort limitation which runs from date of injury,[68] because restricting plaintiff to a contract limitation could lead to the harsh result of barring plaintiff before his tort action accrued.[69] Actions

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for example, the accident occurs in state *A* after *A*'s limitation has run, the injured party might nevertheless be able to sue the manufacturer in an open forum state that would not honor *A*'s procedural statute, but would instead apply its own limitations statute and allow the action to be maintained. *See* Horvath v. Davidson, 148 Ind. App. 203, 264 N.E.2d 328 (1970). The Interagency Task Force recommends that in order to preserve the full effectiveness of a limitation statute, the legislation should be clearly labeled as "part of the substantive law of torts." 7 U.S. DEPARTMENT OF COMMERCE, INTERAGENCY TASK FORCE ON PRODUCT LIABILITY, FINAL REPORT VII-24 (1977).

[62] 54 C.J.S. *Limitations of Actions* § 109, at 11 (1948).

[63] IND. CODE § 16-9.5-3-1 (1976).

[64] Reporting on the Indiana Medical Malpractice Act, IND. CODE §§ 16-9.5-1-1 to 9-10 (1976), *The Wall Street Journal* reported that an attorney who served on the commission which drafted the law, now "calls [the Act] 'the cruelest and most regressive piece of legislation' he has ever seen." The article observed that since the Act was passed in 1975, no patient has won a malpractice suit in Indiana. *Easing the Pain, Problems of Insuring Medical Malpractice Show Signs of Abating,* Wall St. J., Apr. 19, 1977, at 1, col. 1.

[65] *See, e.g.,* Kan. Stat. Ann. § 60-513(7)(b) (1976), and discussion in text accompanying notes 89-91 *infra.*

[66] U.C.C. § 2-725(1), (2) (1972 version).

[67] *See id.* § 2-318, alternatives A, B, & C, which extend a right of action for warranty breach to product users other than the purchaser.

[68] 1 U.S. DEPARTMENT OF COMMERCE, INTERAGENCY TASK FORCE ON PRODUCT LIABILITY, PRODUCT LIABILITY: LEGAL STUDY, at 245 (1977) [hereinafter cited as LEGAL STUDY].

[69] *See* Mendel v. Pittsburgh Plate Glass Co., 25 N.Y.2d 340, 253 N.E.2d 207, 305 N.Y.S.2d 490 (1969), *overruled,* Victorson v. Bock Laundry Machine Co., 37 N.Y.2d 395, 335 N.E.2d 275, 373 N.Y.S.2d 39 (1975).

which rely on tort theory alone are generally governed by the state's tort limitation.[70] These limitations are rules of law and should be distinguished from presumptions, which are rules of evidence subject to rebuttal.[71]

V. Statutes of Limitations Governing Actions for Injury from Products

Relief for injury to person or property from products may be sought under four theories: negligence, breach of express or implied warranty sounding in contract, breach of express or implied warranty sounding in tort, and strict liability in tort. Except for the contractual warranty claims, these actions are normally governed by tort statutes of limitations covering injuries to person or property. However, if the plaintiff joins the contractual warranty theory to his tort-based complaint he may, in many jurisdictions, have the benefit of the tort limitation running from date of injury, as well as the contract limitation running from date of sale.

In 1969, the New York Court of Appeals held that extending such an option to plaintiffs was unfair to defendants. In *Mendel v. Pittsburgh Plate Glass Co.*[72] the court ruled that when plaintiff was not in privity with defendant, breach of implied warranty and strict liability in tort were in fact the same cause of action[73] and were governed by New York's six-year contract limitation which ran from the date of sale and governed Uniform Commercial Code (UCC) warranty actions. The court chose the contract limitation after concluding that it was precluded from applying the personal injury statute of limitations by the New York legislature's adoption of the UCC, which the court held to control "injury to person or property proximately resulting from any breach of warranty."[74] The court concluded that even if not so precluded, the court would be

> willing to sacrifice the small percentage of meritorious claims that might arise after the statutory period has run in

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[70]Legal Study, *supra* note 68, at 45. *But see* text accompanying notes 72-119 *infra* (strict tort action by plaintiff not in privity with manufacturer held by *Mendel* court to be congruent with contractual warranty breach and governed by a contractual statute of limitation).

[71]53 C.J.S. *Limitations of Actions* § 1, at 904 (1948). The application of rebuttable statutory or common-law presumptions to limiting products liability after a specified amount of time will be discussed in text accompanying notes 159-166. In this context, however, a so-called conclusive presumption closely resembles a limitation.

[72]25 N.Y.2d 340, 253 N.E.2d 207, 305 N.Y.S.2d 490 (1969).

[73]In Anderson v. Fairchild Hiller Corp., 358 F. Supp. 976 (D. Alas. 1973), the court found no such congruence under Alaskan law between breach of implied warranty and strict liability theories. Plaintiff, who was time-barred under the Alaskan tort limitation, was denied recovery under a warranty theory statute of limitations (four years from date of sale) because he lacked privity with the manufacturer.

[74]U.C.C. § 2-715(2)(b) (1972 version).

> order to prevent the many unfounded suits that would be brought and sustained against manufacturers ad infinitum. Surely an injury resulting from a defective product many years after it has been manufactured, presumptively at least, is due to operation and maintenance . . . . [W]e must make that presumption conclusive . . . .[75]

With this dicta, the *Mendel* court squarely faced the distinctive policy question found in many product cases: Is it preferable to arbitrarily and prematurely cut off the right of some plaintiffs to sue, or is it better to expose defendants to an indefinite term of liability?[76]

In 1975, the New York Court of Appeals overruled *Mendel* in *Victorson v. Bock Laundry Machine Co.*[77] by allowing plaintiffs to amend a contract action complaint to include a strict liability theory of recovery, thereby permitting the use of the tort statute of limitations running from date of injury rather than the contract limitation running from date of sale. The *Victorson* court adopted the majority view that a tort nexus exists in product-injury cases, whether brought under a strict liability or breach of warranty theory. Defendant's argument that open-ended liability is unfair was rejected. Noting that defendant had derived sufficient benefit from the increase with time of the difficulty of plaintiff's burden of proof, the court concluded that variation in case-to-case considerations made inappropriate a general limitation running from date of sale. Although the court held that the Uniform Commercial Code was not intended to pre-empt the tort limitation rule, the court pointedly did not exclude the use of the Code's contract statute of limitations as an alternative available to the plaintiff.[78]

A result differing from that in *Mendel* was also reached in *Land v. Neill Pontiac, Inc.*,[79] in which a North Carolina court stated, "The North Carolina Supreme Court has consistently held that the cause

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[75]25 N.Y.2d at 346, 253 N.E.2d at 210, 305 N.Y.S.2d at 495. Note that the conclusive presumption called for in *Mendel* is equivalent to an absolute limitation defense.

[76]The *Mendel* holding purported only to govern strict liability actions by "strangers to the contract." *Id.* at 344, 253 N.E.2d at 209, 305 N.Y.S.2d at 493. Parties in privity with manufacturers were already limited to contract warranty or negligence actions. Blessington v. McCrory Stores Corp., 305 N.Y. 140, 111 N.E.2d 421, 122 N.Y.S.2d 147 (1953).

[77]37 N.Y.2d 395, 335 N.E.2d 275, 373 N.Y.S.2d 39 (1975).

[78]The *Victorson* holding was partially based on the fact that plaintiffs were strangers to the contract. The Defense Research Institute (DRI) suggests that the status of those in privity with manufacturers was not resolved in *Victorson*. *Strict Liability Given Tort Nexus*, 16 FOR THE DEFENSE 101, 109 (1975).

[79]6 N.C. App. 197, 169 S.E.2d 537 (1969).

of action accrues at the time of the invasion of the right and that nominal damages, at least, naturally flow from such invasion."[80] Thus, the court found that the rights of a plaintiff who was injured by a negligently installed gas tank were invaded when he purchased his car, not when he was injured three months later. The *Land* court stated further, "The cause of the action accrues at the time of the commission of the negligent act or omission complained of, not at the time of infliction of injuries resulting therefrom."[81]

In *Williams v. General Motors Corp.*,[82] a district court, interpreting North Carolina Supreme Court rulings, pointed out that a plaintiff's action would not accrue in all cases at the time of defendant's negligent act so as to start the limitation running. "[T]he statute starts to run when the first injury, however slight, occurs even if the injury is not discoverable . . . ."[83] If plaintiff were a later purchaser, for example, he clearly would have no cause of action at the time of the first sale. Moreover, the *Williams* court held that the statute had not begun to run on the date of the *later* sale to plaintiff because there was no contractual relationship between plaintiff and manufacturer.[84] The court apparently reasoned that a plaintiff lacking privity with the manufacturer would have no cause of action at the time of the resale to him because the only harm he experienced at that time was economic damage from the defective product. In North Carolina, as in the majority of jurisdictions, the bringing of an action for economic damages still requires privity.[85]

The requirement of slight, although perhaps undiscoverable, injury distinguishes the North Carolina law from a limitation statute which would be independent of plaintiff's cause of action. Yet it seems clear that a pure repose policy has at times supported the judicial interpretation of the North Carolina statute. The *Williams* court noted a number of North Carolina decisions in which the slight injury requirement was ignored, thereby relieving defendants of liability before plaintiffs could maintain an action.[86] The district court concluded, however, that if the North Carolina Supreme Court

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[80]*Id.* at 199, 169 S.E.2d at 538.

[81]*Id.*, 169 S.E.2d at 538-39.

[82]393 F. Supp. 387 (M.D.N.C. 1975), *aff'd*, 538 F.2d 327 (4th Cir. 1976).

[83]*Id.* at 391.

[84]*Id.* at 392.

[85]For an excellent discussion in an opinion which reaches a similar result, *see* Trans World Airlines, Inc. v. Curtiss-Wright Corp., 1 Misc. 2d 477, 148 N.Y.S.2d 284 (Sup. Ct. 1955), *aff'd*, 2 App. Div. 2d 666, 153 N.Y.S.2d 546, § 550 (1956). *But see* Santor v. A. & M. Karagheusian, Inc., 44 N.J. 52, 207 A.2d 305 (1965), in which the court held a remote consumer could recover from the manufacturer for the diminished value of a defective product.

[86]393 F. Supp. at 392.

were to rule on *Williams*, it would follow its early decision in *Hocutt v. Wilmington & W.R. Co.*,[87] which required the showing of some injury to start the statute running.

North Carolina courts reached a position consistent with a nearly pure repose doctrine through a rather strained interpretation of the state's limitation statute, until these harsh results were ameliorated by statute in 1971.[88] In recent years, courts have moved in the opposite direction by *extending* the period wherein plaintiffs can bring their actions, paralleling the New York judicial policy shift from *Mendel* to *Victorson*.

The Kansas Supreme Court reached this liberal result by means of judicial construction and interpretation. In 1973, Kansas enacted a law which appeared to fix a period from time of defendant's act within which an action for injury had to be brought. The relevant section read:

> [T]he cause of action in this section shall not be deemed to have accrued until the act giving rise to the cause of action first causes substantial injury, or, if the fact of injury is not reasonably ascertainable until some time after the initial act, then the period of limitation shall not commence until the fact of injury becomes reasonably ascertainable . . . but in no event shall the period be extended more than ten (10) years beyond the time of the act giving rise to the cause of action.[89]

A trial court subsequently construed this language to bar plaintiff ten years after defendant had acted by installing gas pipes in the plaintiff's house. In *Ruthrauff v. Kensinger*,[90] the Kansas Supreme Court reversed, holding that the ten-year period referred to the time in which plaintiff may reasonably discover her injury. The

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[87]124 N.C. 214, 219, 32 S.E. 681, 683 (1899).

[88]In 1971, the North Carolina General Assembly enacted N.C. GEN. STAT. § 1-15(b) (Supp. 1977) which provides for a limitation in the case of bodily injury or property damage but *excludes wrongful death*, and which runs from the date plaintiff ought to reasonably have discovered the injury or defect. This section also provides "that in such cases the period shall not exceed 10 years from the last act of the defendant giving rise to the claim for relief." The *Williams* court noted that excluding wrongful death actions would lead to product manufacturers being held liable for an indefinite period when the injury results in death. 393 F. Supp. at 391. However, this result would obtain only where the deceased was *not* in privity with the manufacturer. If deceased had purchased a defective product directly from the manufacturer, the limitation would run from the sale date, since the deceased would have had an action at that time under North Carolina case law.

[89]KAN. STAT. ANN. § 60-513(b) (Supp. 1973) (currently codified at KAN. STAT. ANN. § 60-513(7)(b) (1976)).

[90]214 Kan. 185, 519 P.2d 661 (1974).

court noted that the defendant's argument sought to establish "an absolute bar which destroys the right of action before it accrues."[91] It held that such a result would be clearly contrary to legislative intent, since established doctrine in the state required that the limitation begin not only after the action accrued, but also after the plaintiff's discovery of the harm.

These earlier developments of limitation doctrine took place before the recent rapid increases in the frequency and severity of product cases and the accompanying explosion of liability insurance premiums. The current environment has led to products liability legislation on both the state and national levels, including statutes of limitations which run from defendant's act and supplement pre-existing statutes running from time of plaintiff's harm. Although plaintiffs in many jurisdictions enjoy two times at bat, once under a tort limitation and once under contract,[92] it is now proposed that defendants be given two opportunities to bar plaintiffs' action—x years after injury *or* y years after sale of the product.

Connecticut has fixed limitations periods in product cases at three years from injury, but in no case more than eight years from date of sale.[93] Florida allows four years from injury, but in no case more than twelve years from delivery to original buyer.[94] Utah now bars actions commenced more than

> six years after the date of initial purchase for use or consumption, or ten years after the date of manufacture,of a product, where that action is based upon, . . .
>
> (a) Breach of any implied warranties;
> (b) Defects in design, inspection, testing or manufacture;
> (c) Failure to warn;
> (d) Failure to properly instruct in the use of a product; or
> (e) Any other alleged defect or failure of whatsoever kind or nature in relation to a product.[95]

Note that the Utah act does not appear to limit actions from date of defendant's act on account of defendant's negligence. This act also provides that a manufacturer who cannot prove when he first *sold*

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[91]214 Kan. at 187, 519 P.2d at 664.

[92]*See Strict Liability Given Tort Nexus*, 16 FOR THE DEFENSE 101, 109, 116 (1975) for a collection of cases which hold that only one statute of limitations, the personal injury/property damage statute, is applicable to strict liability and negligence actions, while the U.C.C. limitations period is applicable to actions for breach of implied warranty. The article reports that jurisdictions are evenly divided on this question.

[93]CONN. GEN. STAT. ANN., § 52-577a (West Supp. 1978).

[94]FLA. STAT. ANN. §§ 95.031(2), 95.11(3) (Supp. 1977).

[95]UTAH CODE ANN. §§ 78-15-1 to 6 (repl. vol. 9A 1977).

the product or who sold the product more than four years after it was made can still be relieved of liability ten years after *manufacture.*

In 1977, the Colorado legislature, apparently unwilling to absolutely bar a plaintiff-user of a long-lived product, enacted legislation which creates the following rebuttable presumptions ten years after a product is first sold: That the product was not defective, that the manufacturer was not negligent, and that all warnings and instructions were proper and adequate.[96] How this statute will be construed remains to be seen.

On March 10, 1978, Governor Otis Bowen of Indiana signed into law House Enrolled Act No. 1396, the final bill considered by the Second Regular Session of the 100th General Assembly. Although primarily concerned with courts and court officers, the Act also includes a new chapter on products liability.[97] This latter chapter, entitled Statute of Limitations,[98] requires products liability actions to be commenced within

> ten (10) years after the delivery of the product to the initial user or consumer; except that, if the cause of action accrues more than eight (8) years but not more than ten (10) years after the initial delivery, the action may be commenced at any time within two (2) years after the cause of action accrues.[99]

This provision "applies to all persons regardless of minority or legal disability,"[100] and allows a plaintiff two full years to bring an action, so long as the injury occurs within the ten-year limitation.

Other products liability bills are being studied and debated in a substantial number of state legislatures.[101] Common to most of these bills is a statute of limitations or statutory presumption running from date of defendant's act. This proposed legislation is in response to demands from manufacturers, sellers, and insurers, but the relief available to these groups from state legislation is limited, because manufacturers' products will continue to be subject to the laws of the other states in which it is marketed, and insurance rates for

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[96] Colo. Rev. Stat. § 13-21-403(3) (Supp. 1977).

[97] Pub. L. No. 141, sec. 28 (Mar. 10, 1978) (to be codified at Ind. Code §§ 33-1-1.5-1 to 8). This new products liability law, covering causes of action accruing after June 1, 1978, will be discussed in detail in the forthcoming annual Survey Issue of the *Indiana Law Review.*

[98] *Id.* (to be codified at Ind. Code § 33-1-1.5-5).

[99] *Id.*

[100] *Id.*

[101] *See* note 3 *supra.* These bills contain various clusters of the liability-limiting proposals discussed in the text accompanying notes 33-50.

interstate sellers are based on national experience.[102] Although wholesalers and retailers might benefit significantly from isolated state legislation, manufacturers must either hope for widespread state adoption of products liability legislation or they must look to the federal government for relief.

Congress has shown recent concern for this situation, beginning with extensive hearings in 1976 before the Senate Select Committee on Small Business headed by Senator Jacob Javitz.[103] Following a preliminary study conducted by the Bureau of Domestic Commerce, an extensive study of products liability problems was launched in April 1976, by the President's Economic Policy Board, which created an Interagency Task Force.[104] As resource material, these hearings and studies, along with extensive input from legislators' constituencies, have stimulated the introduction of a number of federal products liability bills.

Senate Bill 403, introduced by Senator James Pierson,[105] features an arbitration mechanism which would be instituted in every federal judicial district.[106] In addition, states would be encouraged to create their own arbitration panels.[107] In jurisdictions with such panels, all product litigation would be subject to a preliminary review by the panel in order to determine whether an action should be barred because "injury or damages were sustained after the time period which a reasonable person would expect to be the ordinary useful life of such product."[108] Product injury cases in which the product was more than ten years old, and which survived this preliminary review, would be subject to compulsory binding arbitration.[109] The avowed purpose of substituting arbitration for tort litigation is to "expedite the resolution of cases and controversies"[110] and to bring to bear the knowledge of a panel experienced in law and medicine.[111]

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[102] *See Joint Committee, supra* note 6, at 1 (September 19, 1977) (testimony of Mavis Walters, vice president, Insurance Services Office).

[103] *Impact on Product Liability, Product Liability Problems Affecting Small Business, Hearings before the Select Committee on Small Business,* U. S. Senate, 94th Cong., 2d Sess. (1976).

[104] BRIEFING REPORT, *supra* note 6, at i.

[105] S. 403, 95th Cong. 1st Sess. (1977), *reprinted in S. 403 Hearings, supra* note 4, at 3.

[106] *Id.* §§ 401-405.

[107] *Id.* §§ 501-510.

[108] *Id.* § 604(b).

[109] *Id.* § 604(a).

[110] *Id.* § 102(b).

[111] *Id.* § 403. *See also S. 403 Hearings, supra* note 4, at 275 (remark by Sen. Wendell H. Ford to the effect that he would expect arbitration to result in lower attorney fees).

Senate Bill 1706, introduced by Senator Richard Lugar,[112] provides for a two-year limitation from date of injury combined with a seven-year limitation from date of first purchase or when "otherwise acquired for use or consumption."[113] This provision does not apply to breach-of-warranty actions on long-lived products, such as machine tools, which Senator Lugar suggests will be governed by "express warranties of durations agreed to by commercial parties."[114] His bill specifically cuts off negligence as well as strict liability actions commenced more than seven years from sale of the product.[115]

Also under consideration is proposed federal legislation which would permit self-insurers to deduct contributions to reserves for product liability risks[116] or provide for re-insurance mechanisms.[117] If these non-tort approaches provide sufficient relief to beleagured sellers, there may be less need for major tinkering with the tort litigation system. Establishment of safety standards for products through legislation, such as the Consumer Product Safety Act[118] and the Occupational Safety and Health Act of 1970[119] can more clearly

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[112]S. 1706, 95th Cong. 1st Sess. (1977), 123 CONG. REC. S10030 (daily ed. June 16, 1977).

[113]*Id.* § 201(a).

[114]123 CONG. REC. S10029 (daily ed. June 16, 1977) (remarks of Sen. Richard Lugar).

[115]S. 1706, § 201(a), 95th Cong. 1st Sess. (1977), 123 CONG. REC. S10030 (daily ed. June 16, 1977).

[116]The Internal Revenue Code permits ordinary business expense deductions for products liability insurance premiums under I.R.C. § 162(a). There is, at present, no provision in the Code which would permit a self-insurer to deduct contributions to a reserve fund designed to satisfy product liability claims. However, there are at least three bills before Congress which would authorize limited contributions to such reserves or trusts. S. 1611, 95th Cong., 1st Sess., 123 CONG. REC. S8763 (daily ed. May 26, 1977), would allow corporations to deduct up to three percent of gross sales for contributions to a products liability reserve trust. H.R. 8064, 95th Cong., 1st Sess., 123 CONG. REC. H6647 (daily ed. June 28, 1977), would place the basic limitation at two percent of gross sales. H.R. 7711, 95th Cong., 1st Sess., 123 CONG. REC. H5685 (daily ed. June 9, 1977) (corrected by telephone interview with Mark Rosenberg, assistant to Rep. Charles W. Whalen, on June 29, 1978, in Washington, D.C.), would limit a deduction to the extent which those trust contributions do not exceed the reasonable expense for comparable products liability insurance.

Another approach is suggested in *Doctors and Hospitals Start Insurance Concerns in Caribbean to Beat Malpractice Premium Rises*, Wall St. J., July 6, 1977, at 30, col. 1, which describes the formation of Caribbean-based insurance companies by physician groups in order to provide malpractice insurance under less regulation than would be required of domestic companies. Premiums paid to both American and foreign insurance companies are deductible business expenses.

[117]*See, e.g.*, S. 403, §§ 301-309, 95th Cong., 1st Sess. (1977), *reprinted in S. 403 Hearings, supra* note 4, at 114-23; S. 527, 95th Cong., 1st Sess. (1977), 123 CONG. REC. S1735 (daily ed. Jan. 31, 1977).

[118]15 U.S.C. § 2051 (1976).

[119]29 U.S.C. § 651 (1970 & Supp. V 1975).

define product defects and thereby reduce some of the uncertainty that generates unnecessary litigation.

VI. Statutes of Limitation and the Product Sellers' Conduct

"The fence at the top of the cliff is better than an ambulance in the valley below."[120]

This maxim was quoted by two witnesses, a former president of the American Society of Safety Engineers,[121] and the editor-in-chief of the publication of The Association of Trial Lawyers of America,[122] during testimony before a United States Senate subcommittee which was holding hearings on S. 403. Both witnesses made it clear that the "fence" they referred to included not only actual safety devices and precautions to prevent accidents, but also the tort doctrines which impose liability and assess damages against manufacturers of defective products. To weaken these doctrines by limiting liability in any significant way, they argued, would weaken the "fence" and materially increase the frequency and severity of injury. Mr. MacCollum, the safety engineer, stated that "really it is the court that has been making safety work."[123] He stressed the need for continued pressure on the manufacturer because of the continuing trend to larger and therefore more dangerous equipment.

MacCollum's remarks are particularly relevant with regard to the class of products found in the workplace. A distinction between industrial and consumer products is significant for several reasons. First, industrial equipment generally produces more severe injuries.[124] Second, industrial products are generally longer lived than consumer products. Third, industrial equipment is subject to direct statutory safety regulation. Fourth, the purchaser of an industrial machine is rarely the user; the employer purchases the product but the employee, under varying degrees of economic coercion, is the one who uses it and the one who is subjected to the risk of injury. Fifth, for injury to employees from industrial equipment, a separate comprehensive statutory program, the workers' compensation system, already provides compensation on a no-fault basis. Under workers' compensation, the injured employee recovers his medical costs and a substantial part of his lost wages from his employer's compensation carrier. However, he may also sue the

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[120] *S. 403 Hearings*, *supra* note 4, at 268 & 332 (statements of David V. MacCollum & Thomas F. Lambert, Jr.).

[121] *Id.* at 268 (statement of David V. MacCollum).

[122] *Id.* at 332 (statement of Thomas F. Lambert, Jr.).

[123] *Id.* at 268 (statement of David V. MacCollum)

[124] *Id.* at 268.

manufacturer of the defective product which injured him. Sixth, industrial products, which are capital goods, are usually not mass-produced. A capital goods design decision is not likely to affect as many users as would a consumer product, but this characteristic is counter-balanced by the greater damage potential of a machine-product.

Because of these distinctions, manufacturers of industrial products are subject to a substantially different set of considerations than are manufacturers of consumer products. Therefore, predictions of seller's conduct upon enactment of products liability legislation should be made separately for these two classes of manufacturer-sellers. For example, a statute of limitations running from the date of introduction of the product into the stream of commerce will affect only those products still likely to be in use when the statute has run. Clearly, the impact of such legislation will be felt more acutely by the manufacturers of the longer-lived industrial products. But if, in fact, the safety conduct of the manufacturer of industrial goods is already effectively circumscribed by various other deterrents, enactment of limitation legislation will have little or no effect on conduct—although, of course, it would result in fewer claims. Such deterrents on manufacturers of industrial goods already include laws mandating that the manufacturer install safety devices, laws requiring the employer-purchaser to only operate the products when equipped with safety devices, and market forces penalizing manufacturers of equipment known to be unsafe.

It can also be argued that even if a manufacturer has attempted to cheapen his product in order to take advantage of a new favorable statute of limitations, there would be no practical way he could do so. Under a seven-year-from-date-of-first-sale statute, the manufacturer who seeks to design his product to hold together for seven years will probably find that he would have to manufacture the same safety configurations required for a product designed to last far longer. This proposition suggests that there is no way to design and build a less-than-wonderful "one hoss shay" embodying a safety system which will last precisely seven years.

However, manufacturers do indeed make decisions regarding design and manufacture specifications based on product and component life. When liability is open-ended as to time, some of these decisions are undoubtedly resolved in favor of increased component longevity. But when liability is cut off after a fixed period, this decision may easily go the other way, especially when the longer-lived solution is significantly more expensive.[125] To what extent manufac-

[125]It might be argued that capital goods manufacturers are less sensitive than consumer manufacturers to cost considerations governing material and component life.

turers may be motivated to skimp on safety as a result of a statute of limitations running from date of first introduction of a product into the stream of commerce is not known, but perhaps a preliminary prediction can be derived by noting that when products liability insurance premiums began to rise dramatically in the mid-1970's, manufacturers, especially large ones, substantially increased their safety system budgets.[126] The Interagency Task Force Briefing Report noted:

> While our data base is not extensive, it suggests that [the] tort-litigation system and the use of product liability insurance premiums have been an effective spur toward inducing manufacturers to produce safe products.
>
> Thus, in considering any modifications in the tort-litigation system, one must be careful not to diminish pressure on manufacturers toward employing sound product liability prevention technique programs.[127]

It should be emphasized, however, that unlimited allocation of resources to "fool-proof" safety technology may not be an entirely positive development. Some rates of expenditure cannot be justified by reduced risk.[128] There may also be a point where it does not pay to shift a risk to a seller from a user who may be the better risk-avoider.[129]

Increases in the cost of accidents may stimulate manufacturers not only to alter their safety programs but also to review their plans to develop and market new products. The introduction of a new product produces uncertainties for the manufacturer that frequently extend far into the future. The Interagency Task Force Briefing Report noted some adverse effects on new product develop-

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Selecting a stainless steel part rather than an iron casting is not a significant cost decision when measured against, say, a $100,000 selling price for the product. But for capital goods manfacturers it is not at this decision point that the safety costs are incurred; it is the safety *design* procedure that is expensive. *Determining* that specifying the stainless part would make a difference in the number and severity of injuries some years down the road is the manufacturer's costly process, a process which might be cut back if the manufacturer's liability were limited by statute.

[126] BRIEFING REPORT, *supra* note 7, at 10.

[127] *Id.* at 10.

[128] "At some point the emphasis can be so great that it is not economically justified. If one spends $10 million to make a Dixie cup safer, that is wasteful." *S. 403 Hearings*, *supra* note 4, at 47 (testimony by Professor Victor Schwartz).

[129] "There is a school of economic thought that suggests . . . it is economically wasteful to force manufacturers to employ more product liability prevention techniques or devices than may be necessary in light of the fact that the user or consumer is sometimes the most 'efficient accident cost avoider.' " BRIEFING REPORT, *supra* note 7 at 10.

ment, particularly in the pharmaceutical industry.[130] This development may be due in part to the difficulty of reliably predicting judicial standards for liability and the fact that both plaintiff and defendant may incur substantial litigation costs, even when no action properly lies. The natural response of manufacturers to these risks is a conservative product development policy. The Interagency Task Force found this result to not be totally adverse, since it may prevent development and sale of unreasonably unsafe products.[131]

Opponents of state statutes of limitation which run from the date of first introduction into the stream of commerce point out that enactment will create geographical areas where old products may be sold with immunity from liability. Sellers will then be motivated to "dump" these aged and presumably dangerous products in the immune states.[132] Whether such laws will in fact provide sufficient inducement to significantly distort the marketing patterns of these products is at present undetermined, but recent passage of state statutes in Utah, Connecticut, Florida, and Indiana may soon provide evidence on the issue.

VII. Proposed Approaches to Balance the Equities

This Note has described the tension between the plaintiff's right to sue within a reasonable time after he is injured and the defendant's right to be free of the threat of litigation after a reasonable time has elapsed following a possibly injurious act. When the injurious effect of a defendant's act may be delayed for an extended period, these rights and interests of the plaintiff vis-a-vis the defendant cannot be resolved absolutely and must therefore be

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[130]In Gottsdanker v. Cutter Laboratories, 182 Cal. App. 2d 602, 611, 6 Cal. Rptr. 320, 326 (1960), the court recognized but rejected defendant's argument "that public policy will best be served by denying recovery in warranty for 'new' drugs. The argument is that development of medicines will be retarded if manufacturers are held to strict liability for their defects."

In 1977, the Interagency Task Force noted that although manufacturers of "unavoidably" unsafe pharmaceuticals may be insulated from liability, the threat of a lawsuit in which it will be *determined* whether the product is to be ruled "unavoidably unsafe" may be sufficient to inhibit product development. Briefing Report, *supra* note 7, at 9-10.

[131]*Id.* at 10, 16.

[132]*See* Indiana Trial Lawyers Association, Urgent Legislative Bulletin (March 25, 1977) (available from ITLA Legislative Committee, 6201 Carrollton Avenue, Indianapolis, Indiana 46220). "Such legislation [SB 70] will make Indiana a dumping ground for every poorly-designed and poorly-made product imaginable. How would you like to ride an elevator on the basis of such a limitation of manufacturer responsibility . . . or an aircraft?"

balanced. Manufacturers,[133] middlemen,[134] liability insurance carriers,[135] and the defendants' bar[136] argue that the rapid acceptance of the strict liability doctrine by the courts, together with a growth in "consumerism," have created a heavy imbalance favoring the plaintiff. This imbalance, they assert, has led to the products liability "crisis" discussed earlier.[137] The widely varying proposals for limitation legislation reflect the efforts of legislatures and interested groups to redress this perceived imbalance.

A threshold issue presented with considerable clarity by the Defense Research Institute (DRI)[138] is whether statutes of repose are appropriate or constitutional in the area of products liability. The DRI distinguished between statutes of limitation, which run when a plaintiff's claim accrues, and statutes of repose, which begin to run at the time of defendant's act, such as the introduction of the product into the stream of commerce.[139] Sellers' groups propose that such repose statutes should replace or supplement limitation statutes.[140]

A DRI Position Paper noted that statutes of repose have been successfully challenged in some courts on the ground that they violate the federal constitutional guarantee of equal protection, because some plaintiffs may be barred before their claims arise.[141] The Wisconsin Supreme Court found such a statute to be barred by a provision in its state constitution which guaranteed a legal remedy for all injuries.[142] Other courts have upheld such statutes in non-product cases when the statutory language required the action to be brought within a given number of years "of the act or commission complained of."[143] The DRI reports that only one products liability

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[133]*See, e.g.*, *S. 403 Hearings*, *supra* note 4, at 91 (statement by Paul Benke, vice president, AMF Marine Product Group).

[134]*See, e.g.*, *id.* at 121 (statement by William C. McCamant, executive vice president, National Association of Wholesaler-Distributors).

[135]*See, e.g.*, *id.* at 281 (statement by Andre Maisonpierre, vice president, American Mutual Insurance Alliance).

[136]*See, e.g.*, *id.* at 62 (statement of Louis A. Lehr, Jr., attorney with Arnstein, Gluck, Weitzenfeld & Minow).

[137]*See* text accompanying notes 6-32 *supra.*

[138]The DRI is a nonprofit corporation organized "To Increase the Professional Skill and Enlarge the Knowledge of Defense Lawyers." DRI, PRODUCTS LIABILITY POSITION PAPER NO. 9, (1976) [hereinafter cited as POSITION PAPER].

[139]*Id.* at 20.

[140]*See* Maisonpierre, *supra* note 135, at 289; Lehr, *supra* note 131.

[141]POSITION PAPER, *supra* note 138, at 21.

[142]Kallas Millwork Corp. v. Square D Co., 66 Wis. 2d 382, 225 N.W.2d 454 (citing WIS. CONST. art. 1, § 9).

[143]POSITION PAPER, *supra* note 138, at 21.

statute has been construed (in dicta) to uphold a ten-year-from-date-of-sale repose statute where a plaintiff is injured but not killed.[144]

The DRI, recognizing the constitutional problem, proposes that plaintiff should be allowed to retain his right to bring a negligence action, subject only to a limitation running from date of injury or plaintiff's discovery of the injury.[145] Thus, a repose statute would bar only strict liability actions"—years after the product was first sold."[146]

A commentator for the Independent Insurance Agents of America, Inc. (IIAA) has suggested that permitting plaintiff to retain his right to bring product actions under a negligence theory after a repose statute for strict liability has run would not in practice restore the balance in favor of defendant. He predicts that the courts would then liberalize the negligence rule to allow what are in reality strict liability cases to be litigated under the doctrine of res ipsa loquitor.[147] A similar view has been expressed by the vice president of a large insurance brokerage firm, who suggests that "results of cases decided under the traditional cause of action [negligence] would probably not have been materially different given the current environment of increased consumer expectation."[148]

Assuming that the constitutionality of a repose doctrine is upheld, the task of balancing the equities becomes the choosing of the proper time period in which liability should attach. For example, capping liability five years from date of first sale would obviously affect far more products, industries, and claims than would a ten-year repose provision.

Existing and proposed legislation provides for liability caps ranging typically from five[149] to twelve[150] years. Until recently, however, there was no substantial data to aid the drafters of limitation legislation who sought to gauge the probable impact of specific statutory liability periods on claims. In 1977, however, the

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[144]Raftery v. Wm. C. Vick Const. Co., 29 N.C. App. 495, 224 S.E.2d 706 (1976) (discussing N.C. Gen. Stat. § 1-16(G) (Supp. 1975)), *aff'd*, 291 N.C. 180, 230 S.E.2d 405 (1976). *See* discussion in note 88 *supra*.

[145]Position Paper, *supra* note 138, at 21.

[146]*Id.* at 22.

[147]*S. 403 Hearings*, IIAA Memorandum, *supra* note 33, at 462 (statement of Jeffrey M. Yates, assistant general counsel, IIAA).

[148]O'Sullivan, Product Liability and Tort Reform (1977) (article published and distributed by Marsh & McLennan, Inc., 200 Clarendon Street, Boston, Mass. 02116).

[149]Ind. H.B. 1587 (1977) provided in part that "action for the recovery of damages for personal injury, death, or damage to real or personal property . . . shall be brought within five (5) years of the date the product was first purchased for use or consumption . . . ."

[150]*See* discussion of proposed liability cap by Jeffrey Yates, *S. 403 Hearings*, IIAA Memorandum, *supra* note 33, at 461.

American Mutual Insurance Alliance (AMIA) published a survey of large-loss product liability claims.[151] The data provided by eight of the Alliance's member insurance companies on claims in 1975 involving combined losses and expenses in excess of $100,000 led to the conclusion that a six-year repose statute would have cut off 12.6% of payments to claimants.[152]

A far more comprehensive Product Liability Closed Claim Survey prepared by the Insurance Services Office (ISO) was released in late 1977.[153] This report analyzed the results of 24,452 survey forms submitted by twenty-three insurance companies and encompassed claims closed between July 1, 1976, and March 15, 1977.[154] The report disclosed that 14.2% of payments to claimants were for injuries sustained more than six years after the product was manufactured.[155] The fact that 14.2% of the total amount was paid out to only 4.8% of the claimants[156] supports the proposition that longer-lived products cause more severe accidents. The ISO survey noted that twelve years after manufacture 5.7% of the amount of payments for bodily injury was still to be made.[157] These statistics, if assumed reasonably valid for future projections, can provide the tool whereby drafters of legislation can determine the consequences of specifying a particular liability cap.

The IIAA commentator proposes a twelve-year liability cap for manufacturers, since the ISO survey suggests that relatively few claims would be affected by such a limitation. He further proposes that strict liability should be applied against resellers, modifiers, and repairers of products for an additional twelve-year period running from the date of such acts.[158] This generous liability period and expansion of the seller-defendant class appears to be a trade-off for the application of a repose statute to negligence as well as strict liability actions. As can be seen, the absolute defense of a repose statute is capable of wide variety: Vary the liability cap, the applicable theories, or the class of defendant—and the equitable balance is shifted significantly.

But if the validity of a repose statute absolute defense is rejected on equitable, constitutional, or public policy grounds, other

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[151]AMIA, Survey of Large-Loss Products Liability Claims (1976) (available from American Mutual Insurance Alliance, 20 North Wacker Drive, Chicago, Ill. 60606).

[152]*Id.* at 4.

[153]INSURANCE SERVICES OFFICE, PRODUCT LIABILITY CLOSED CLAIM SURVEY (1977) [hereinafter cited as ISO Survey].

[154]*Id.* at 7.

[155]*Id.* at 81.

[156]*Id.*

[157]*Id.*

[158]*S. 403 Hearings*, IIAA Memorandum, *supra* note 33, at 461.

approaches can be considered to restore weight to the defendant's position. One such approach is to increase the plaintiff's burden of proof by requiring him to overcome a statutory presumption that the long-lived product that injured him was not defective at the time of sale, since it had served for many years without causing injury.[159] The intended result of such a statutory presumption would be to discourage litigation of all but the clearly meritorious claims. Whether such a law would in fact provide such a benign filter would depend heavily on judicial interpretation of the standard necessary to rebut the presumption. For example, evidence that the product had been very lightly used during the statutory period would tend to rebut the presumption that the defect causing the injury arose only after a product life of normal wear and tear.

But should the courts be required to determine standards of normal product usage? The Indiana Supreme Court in *J.I. Case Co. v. Sandefur*[160] stated the following:

> This brings us to the question of the age of the machine and the lapse of time since its manufacture. We judicially know that no machine can be made perfect, nor can one last forever. It degenerates with age. There comes a time when some part wears out or breaks. It does not, as the proverbial "One-Hoss Shay," totally disintegrate and fall apart all at one time.
>
> No evidence was offered as to the useful life of the combine in question. Evidence was offered to show that the machine, although 5 years old, was but slightly used the first four years . . . . Its life and its physical condition is a question of fact to be determined in the trial.[161]

Clearly courts do rule, even without benefit of statutory guidelines, that a product was or was not defective at time of first sale based on a determination that the product has or has not outlived a period of normal service. But the imposition of statutory guidelines should generate greater uniformity and predictability, thereby reducing doubtful litigation without arbitrarily barring a significant number of meritorious cases. As the court in *Victorson v. Bock Laundry Machine Co.*,[162] concluded after overruling the New York repose doctrine established in *Mendel v. Pittsburgh Plate Glass Co.*,[163] there is

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[159]*See* COLO. REV. STAT. § 13-21-403(3) (Supp. 1977) and discussion in text accompanying note 96.

[160]245 Ind. 213, 197 N.E.2d 519 (1964).

[161]*Id.* at 222, 197 N.E.2d at 523.

[162]37 N.Y.2d 395, 335 N.E.2d 275 (1975).

[163]25 N.Y.2d 340, 253 N.E.2d 207 (1969).

too much variation in facts from case to case to permit a general rule of repose.

A statutory presumption of normal product life can be established as a fixed period for all products, as provided in the Colorado statute,[164] or it can be based on a determination of the "useful life" of the product. This determination can be made by governmental agencies or arbitration panels, or it can be established by manufacturers through disclaimers. The latter proposal, although easy to administer, "would give rise to litigable issues surrounding their adequacy and effectiveness."[165] Senate Bill 403 uses a combination of approaches, calling for an arbitration panel to determine useful life for products less than ten years old, coupled with a provision that ten-year-old products are presumed to have originally been nondefective. A plaintiff who wishes to rebut that presumption *must* submit the issue to arbitration.[166]

As noted, the balance of equities between the parties can be affected by changes outside the tort law area. Laws directed toward the improvement of the delivery of insurance, greater rationalization of the rate-making procedure, or overhaul of the tax laws inhibiting self-insurance reserves might make so-called tort reform unnecessary.

If tort law modification is found to be necessary, certain proposals designed to balance the equities may be preferable to others. For example, one proposal that might obviate the need for repose statutes is a suggestion developed by Professor Jeffrey O'Connell, the well-known proponent of applying no-fault principles to accident cases. Professor O'Connell begins with two observations. First, tort litigation is shockingly slow, uncertain and inefficient. Product cases typically take years to adjudicate, and the likelihood of plaintiff's recovery is usually in doubt until the very end.[167] Ultimately, net plaintiffs' recoveries are less than one-half of the total costs incurred by products liability insurers.[168] Second, O'Connell notes, citing

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[164]COLO. REV. STAT. § 13-21-403(3) (Supp. 1977).

[165]LEGAL STUDY, *supra* note 68, at 48.

[166]S. 403 § 604(a), (b), 95th Cong. 1st Sess. (1977), *reprinted in S. 403 Hearings*, *supra* note 4, at 33-34.

[167]"This, then is the present tort insurance system: not a system for paying accident victims from accident insurance (as sensible as that simple idea would seem to be), but a system for *fighting* accident victims about paying them from accident insurance; a system so cumbersome and tricky that the typical accident victim 'even after consulting a lawyer . . .' cannot know *what* he will be paid, *when* he will be paid, or *if* he will be paid; a system hugely wasteful . . . ; a dilatory system . . . , with the outcome more dependent on luck and emotion than on need and reason." O'CONNELL, ENDING INSULT TO INJURY: NO-FAULT INSURANCE FOR PRODUCTS AND SERVICES, 54 (1975).

[168]The ISO Survey, *supra* note 153, at 11, notes that for every dollar of claim payment in personal injury cases, there are an additional thirty-five cents of defense costs

the ISO Survey, that "about one-half of the total of product liability payments for personal injury goes to employees injured on the job and therefore presumably already covered by workers' compensation."[169] Because the workers' compensation system is not fault based, it is fast, certain and efficient, returning about seventy percent of the insurance dollar to the injured party,[170] beginning as early as one week after the accident is reported. O'Connell proposes that the sole remedy to employees for workplace accidents should be a claim for workers' compensation.[171]

The industrial products which injure employees tend to be far longer lived than consumer products. Since injuries by industrial products result in forty-two percent of total recoveries in product cases,[172] presumably a substantial percentage of these claims would be barred by statutes of repose. Although the ISO survey does not provide this precise statistic, the available figures appear to warrant the assumption that barring employee claims against industrial product manufacturers would sharply reduce the potential number of "old" product claims. Therefore, adoption of such a proposal could sufficiently reduce the exposure of the most seriously affected industries, rendering the absolute defense of statutes of repose no longer so urgent.

Yet, reduction of this exposure provides one of two major criticisms of the O'Connell proposal, since modification of liability could adversely affect seller's conduct by reducing the seller's incentive to seek improved safety systems.[173] O'Connell answers this problem by suggesting that the employer-purchaser retain the right to maintain a third-party action against the product manufacturer, but under comparative negligence principles. The employer or his compensation carrier could, for example, only recover sixty percent of his compensation payment to the injured worker from the machinery manufacturer if the manufacturer could show that the employer's negligence constituted forty percent of the cause of the accident.[174] Although this restoration of the employer's right to sue the

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or twenty-six percent of total costs. Plaintiff's attorney fees, expenses and expert witnesses are probably somewhat higher than defendant's defense costs, thereby leaving plaintiff with a net recovery of less than one-half of the defendant insurer's loss.

[169]Sole Remedy, *supra* note 46, at 1.

[170]*See* A. Conard, J. Morgan, R. Pratt, C. Voltz & R. Bombaugh, Automobile Accident Costs and Payments 59, 61 (1964). In contrast, the authors found that only 44% was paid out as net benefits under the tort liability system.

[171]Sole Remedy, *supra* note 46, at 1.

[172]ISO Survey, *supra* note 153, at 62. Note that 42% of the payments go to 10.6% of the parties. *Id.*

[173]*See* text accompanying notes 125-127 *supra.*

[174]Sole Remedy, *supra* note 46, at 1-2.

manufacturer under products liability theories would reduce the relief promised by making workers' compensation a sole remedy, the stakes would be substantially lower, since workers' compensation provides payment for economic loss only. Pain and suffering awards are removed from the system, and contingency fees are lower and strictly regulated.[175] Also, workers' compensation is generally on a pay-as-you-go basis, with temporary total disability awards ceasing if the injured employee should recover his health sooner than expected. Finally, since the remaining product litigation under this proposal would be between business entities who are or have been dealing with each other, nuisance suits and doubtful claims would be reduced, and settlement potential would be enhanced, particularly in view of the fact that the dollar amounts in issue would be reduced. Also, allowing the partial defense of the employer's negligence should sharply reduce third-party claims against product manufacturers.

A second, and probably more serious, objection to shifting liability from product manufacturer to employer through the "sole remedy" proposal is that the injured worker would lose a significant right of action available to other classes of injured plaintiffs. This loss is emphasized by the general inadequacy of workers' compensation payments. Noting this inadequacy suggests the solution. O'Connell believes that increasing the worker's compensation payment schedules under national guidelines would provide a trade-off which would be acceptable to both labor and business interests.[176] Such a quid pro quo should eliminate constitutional objections and provide efficient *uniform* protection to workers, regardless of whether they are injured by old or new products, or by nonproduct workplace conditions.

Another effect of shifting much of the product defect risk from manufacturer to employer would be to spread the risk over many more business enterprises. Employer-purchasers of industrial products certainly outnumber manufacturer-sellers. But if this proposal is more efficient at loss-spreading than the present system, what effect will it have on the rate of accidents?

Perhaps the most efficient loss-spreading mechanism would be externalization of accident costs through socialization, as practiced in New Zealand.[177] American policy, however, remains committed to

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[175]O'Connell suggests, however, that the employer should succeed to the employee's entire tort claim, including pain and suffering, when the employee is injured by a third party who is not a workers' compensation employer, *e.g.*, where the worker is injured on the job by a non-commercial vehicle. *Id.* at 3.

[176]*Id.* at 1.

[177]*See* Palmer & Lemons, *Toward the Disappearance of Tort Law—New Zealand's New Compensation Plan,* U. Ill. L. F. 693 (1972). As originally conceived, the New

assigning liability to the enterprises best able to take the corrective action designed to reduce future similar accidents. In the workplace context, the employer-purchaser is more likely to be the designated enterprise than the manufacturer-seller. Moreover, among the employer, employee, and product manufacturer, it is the employer who can make the greatest contribution to the safety system. The employer selects the equipment; hires, trains, and supervises the employees; sensitizes the workplace environment to safety considerations; maintains and replaces the equipment; modifies the components for new tasks; and provides first aid and other post-accident mechanisms. As the product ages, the employer's share of this control increases. Thus, a proposal which makes the employer the primary obligor for all compensation to injured workers could appear just.

Shifting the risk to the employer is not as onerous as it may first appear. The employer would retain the right to sue the manufacturer of a defective machine, and he would benefit significantly from the reduction in the purchase price of the industrial product, such price reduction resulting from the reduced burden of products liability insurance on the manufacturer.

Arguably, although adoption of workers' compensation as a sole remedy for injured workers might reduce the nation's overall products liability insurance costs, it would supply this relief unevenly and inequitably, because manufacturers of consumer products would continue to be subject to open-ended liability.[178] Although uneven, this proposal is, nevertheless, consistent with recent public policy directed toward special protection for consumers.[179]

VIII. Conclusion

Numerous proposals have been advanced to deal with the increasing frequency and severity of product-related accidents and a

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Zealand plan provided for a compulsory program which would provide compensation for accidents occurring in the workplace, highway, and home. As implemented, the act covers motor accidents and accidents to earners in the workplace and, to a lesser extent, outside the workplace. The enacted plan does provide some general deterrence by assessing penalties against industries, employees, or individuals that experience greater than "normal" accident rates, but there is no requirement that fault, defect, or causation be proven in order to recover from the system.

[178]Professor O'Connell suggests that litigation could be more easily replaced by less costly arbitration when the parties are business entities. He suggests further that third-party actions could be eliminated by contract at the time of sale, the employer giving up his third-party right of action in exchange for a lower price for the product. Sole Remedy, *supra* note 46, at 2.

[179]*See, e.g.*, Flammable Fabrics Act, 15 U.S.C. § 1191 (1976); 15 U.S.C. § 1211 (1976) (household refrigerators); Poison Prevention Packaging Act of 1970, 15 U.S.C. § 1471 (1976); Consumer Product Safety Act, 15 U.S.C. § 2051 (1976).

concomitant explosion of insurance premiums. One set of proposals suggest modification to tort laws, including a statute of limitations, or more properly a statute of repose, to run from the date of manufacture or from the date seller first introduces the product into the stream of commerce. Such a statute, however, may have the unconstitutional and inequitable effect of barring plaintiffs before their claims accrue.

This Note has dealt with the tension inherent in the proposals designed to balance the equities between sellers and users without encouraging the seller to cut back on safety mechanisms so as to increase the risk of accident. The efficiency and predictability of the present compensation delivery systems have been considered, and the analysis suggests that changes may be needed. Our present tort litigation system is wasteful and uncertain, but introduction of an absolute defense which would arbitrarily bar meritorious claims through no fault of the plaintiff is clearly inequitable, perhaps unconstitutional, and probably unnecessary. The quest for a solution should focus first on mechanical problems, such as insurance delivery and tax law distortion. Only then should consideration be given to modifying established legal doctrines, examining first those principles that are least fundamental to the legal fabric.

The evidence indicates that a satisfactory rebalance of interest and equities in the direction of defendant-sellers may be achievable without introduction of repose statutes. Exhaustive analysis should be given a plan to apply no-fault principles to the products problem through the vehicle of workers' compensation, as well as the proposal allowing the use of rebuttable statutory presumptions. Enactment of "misuse," "state of the art," and "later modification" defenses may be preferable to passage of repose statutes and would cut off most of the same claims. However, if a repose doctrine is accepted, its effect may be tempered by applying it to strict liability cases only or by providing generous liability caps. If tort law modifications are to be adopted they should be directed against the slowness and inefficiency of the tort system and should foster conduct designed to reduce accidents.

Product liability is like a box that's ticking.
We don't know what's inside, a clock or a time-bomb.[180]

JORDAN H. LEIBMAN

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[180]Headline from a full-page advertisement placed by Travelers Indemnity Company in several national magazines, *e.g.*, TIME, April 25, 1977, at 35. The purpose of the advertisement was to inform readers that the products liability problem is about to "blow up." Similar ads have been placed by other insurance companies. *See, e.g.*, Aetna Life & Casualty's "Too bad judges can't read this to a jury . . . ," showing the

judge holding a jury instruction which points out that judgments must be indirectly paid by uninvolved parties through insurance premiums, TIME. Feb. 20, 1978, at 65; "And now, the big winners in today's lawsuits . . . ," which points up the "lottery" aspects of the tort litigation system with examples of seemingly outrageous awards, *id.* at 88-89.

Plaintiffs' lawyers have begun to complain about these advertisements to the F.T.C., and in February 1978, a lawsuit was filed in Connecticut charging insurance companies "with what amounts to jury tampering." *Ford's $128.5 Million Headache, id.* at 65.

Although the Travelers' ad may underline the explosiveness of the products liability issue, it can also serve to forcefully remind us that many of the products we purchase, use, or merely come near are themselves "ticking."

The Due Diligence Defense in Rule 10b-5: The *Hochfelder* Aftershocks

The private remedy under rule 10b-5[1] is entirely a creation of judicial decisions. The district court decision in *Kardon v. National Gypsum Co.*[2] started the judicial discussion concerning the formation of requirements for recovery in a private action under rule 10b-5. With limited legislative guidelines, the burden of defining the requirements for private enforcement of securities laws has been left to the courts.[3] The development of a private recovery under rule 10b-5 has focused primarily on the elements of the defendant's conduct and the prerequisites for recovery.[4] Courts have held some traditional equitable defenses applicable to rule 10b-5 cases.[5] However, frequently the courts have imposed on the plaintiff a duty of due care or diligence. This duty is sometimes described as requiring the plaintiff to demonstrate that his reliance was reasonable or justifiable.[6] A more general and applicable definition is that where the plaintiff's conduct was unreasonable and contributed to his own harm, he will not be allowed to recover. Various courts have used

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[1]Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1977), states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interestate [sic] commerce, or of the mails or any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Rule 10b-5 was promulgated pursuant to § 10(b) of the Securities and Exchange Act, 15 U.S.C. § 78j(b) (1976).

[2]69 F. Supp. 512 (E.D. Pa. 1946), *addressing merits*, 73 F. Supp. 798 (E.D. Pa. 1947). The private remedy under rule 10b-5 was implied under RESTATEMENT (SECOND) OF TORTS § 286 (1965), which deals with the implied right of action for negligence.

[3]Dupuy v. Dupuy, 551 F.2d 1005, 1013 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977).

[4]Generally, the requirements for recovery in rule 10b-5 are as follows: A material misrepresentation or omission by the defendant, a showing of scienter, reliance, and some form of due diligence by the plaintiff. *Id.* at 1014.

[5]Ocrant v. Dean Witter & Co., 502 F.2d 854 (10th Cir. 1974) (latches and estoppel used as a defense); James v. DuBreuil, 500 F.2d 155 (5th Cir. 1974) (*in pari delicto* defense); Landry v. Hemphill, Noyes & Co., 473 F.2d 365 (1st Cir.), *cert. denied*, 414 U.S. 1002 (1973), *reh. denied*, 415 U.S. 960 (1974) (waiver used as a defense).

[6]Dupuy v. Dupuy, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied*, 434 U.S. 411 (1977). *See* Wheeler, *Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense to an Implied Remedy*, 70 NW. U.L. REV. 561, 563 (1975).

different rationales and standards in dealing with the due diligence issue, but the majority of jurisdictions require some showing of due diligence.[7] While once well established, the duty of due diligence is presently being questioned. This Note will trace the judicial development of due diligence, assess its theoretical validity, and discuss its applications.

I. Early Judicial Development of the Duty of Due Diligence

Courts have generally dealt with the due diligence issue in the context of a flexible duty standard (variable disclosure),[8] reliance,[9] materiality,[10] general equitable considerations,[11] and as a separate element in rule 10b-5 actions.[12] Despite these diverse approaches, the plaintiff's failure to exercise due diligence will preclude his 10b-5 recovery.

The flexible duty approach incorpates the plaintiff's duty of due care into the scope of the defendant's duty to disclose. This approach was used by the court in *Arber v. Essex Wire Corp.*[13] when the president-purchaser of corporate stock did not reveal the book value of the corporate stock to the sellers. The book value of the stock and other financial information was easily obtainable from the records of the corporation. The court held there was no duty for a corporate insider to reveal routine, easily obtained corporate data.[14] The sellers of the stock were not permitted to recover because they were charged with constructive knowledge of the contents of the corporate records.[15] The narrow holding in *Arber* is of limited value

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[7]The following circuits have recognized some form of due diligence defense: Rogen v. Ilikon Corp., 361 F.2d 260 (1st Cir. 1966); Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275 (2nd Cir. 1975); Rochez Bros., Inc. v. Rhoades, 491 F.2d 402 (3d Cir. 1975), *cert. denied*, 425 U.S. 993 (1976); Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971), *reh. denied*, 404 U.S. 874 (1971); Arber v. Essex Wire Corp., 490 F.2d 414 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963); City Nat'l Bank v. Vanderboom, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); White v. Abrams, 495 F.2d 724 (9th Cir. 1974); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971), *reh. denied*, 404 U.S. 1064 (1972) (Mitchell), *cert. denied*, 405 U.S. 918 (1972) (Reynolds).

[8]White v. Abrams, 495 F.2d 724 (9th Cir. 1974); Arber v. Essex Wire Corp., 490 F.2d 414 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974).

[9]City Nat'l Bank v. Vanderboom, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963).

[10]Taylor v. Smith, Barney & Co., 358 F. Supp. 892 (D. Utah 1973).

[11]Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963).

[12]Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971).

[13]490 F.2d 414 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974).

[14]*Id.* at 420.

[15]*Id.*

when trying to develop a workable standard under the flexible duty rationale, because the court did not further define what information a defendant must reveal beyond that which is routinely available in corporate records.

A more extensive discussion of the flexible duty approach was undertaken by the court in *White v. Abrams.*[16] In *White*, the plaintiff was advised by the defendant, a long time friend and advisor, to invest a considerable sum in several companies. The defendant misrepresented the financial condition of the companies, and the plaintiff invested his money based upon these false representations. After learning the true facts, the plaintiff sued under rule 10b-5, and the trial court imposed absolute liability on the defendant for his mispresentations. The Ninth Circuit Court of Appeals reversed and adopted the flexible duty rationale as a gauge for the defendant's conduct.[17] The court outlined a variable disclosure standard based on the relationship between the plaintiff and the defendant, the defendant's access to information, the benefit the defendant derived from the relationship, the defendant's awareness of the plaintiff's reliance upon the relationship in making the investment decision, and representations made by the defendant for the purpose of inducing the plaintiff to enter the transaction.[18]

Under the *White* test, the defendant's duty to disclose information varies depending on the particular fact situation.[19] The defendant's duty is to disclose *only* that material information to which the plaintiff has no access, and consequently, the plaintiff's duty of due diligence is derived from what the defendant does not reveal. The plaintiff's status and the particular circumstances of each case determine whether he has exercised due diligence. If a defendant omits or misrepresents information to which the plaintiff has no reasonable access, he will be liable. On the otherhand, if the omission or misrepresentation involves facts to which the plaintiff has reasonable access, the plaintiff will not recover.[20]

The most significant aspect of the flexible duty approach is that it does not always require a full and accurate disclosure. The level

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[16]495 F.2d 724 (9th Cir. 1974).

[17]*Id.* at 734.

[18]*Id.* at 735-36.

[19]*Id.* at 736.

[20]Arber v. Essex Wire Corp., 490 F.2d 414 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974). An illustration of a typical flexible duty analysis is one in which the plaintiff is an insider and thus has access to most information. The defendant's duty to disclose is then limited to that information which the plaintiff cannot reasonably obtain, and the plaintiff is charged with the constructive knowledge of the omitted information he could have easily obtained. With a less sophisticated insider the defendant must correspondingly increase his level of disclosure.

of disclosure is dependent upon the particular plaintiff and the particular factors that are present. With a multitude of fact situations and differing levels of sophistication among plaintiffs, defendants' duties of disclosure can vary significantly.[21] The variable disclosure approach is inconsistent with SEC enforcement procedures where the defendant is found guilty whenever he fails to make a complete and accurate disclosure.[22] When the SEC attempts to deter fraudulent conduct it is not relevant "that [claimant] might have been a knowledgeable investor."[23] A flexible duty analysis that allows the defendant's duty to disclose to be determined by the particular circumstances of the case encourages inconsistent standards of conduct. If the defendant is already required to make a complete disclosure, it seems reasonable that the plaintiff, despite his investment status, should also gain from the benefits of the disclosure. If an SEC enforcement procedure were made contingent upon a violation of a flexible duty disclosure, it would have limited availability. An additional difficulty with the flexible duty approach is that it imposes a tremendous burden upon the defendant. Before instituting any transaction, the defendant must first determine what is to be disclosed to the plaintiff. A large scale securities broker with many clients is hard pressed to make his disclosure decisions in an efficient and accurate manner. He must first collect and categorize all the available information and then parcel it out depending upon the client with whom he is dealing. As a result, the defendant is able to define his own liability. There is no consistency in this approach, and it provides no identifiable standard of conduct.[24] With no identifiable set of standards by which the defendant's disclosure duty may be gauged, the only practical method by which the potentially defrauded plaintiff may assess the validity of his claim is to bring a rule 10b-5 suit. This situation invites spurious claims and an unwarranted expansion of rule 10b-5 litigation.

One of the most popular treatments of the due diligence issue is to link the due care question to the plaintiff's reliance.[25] Under the reliance approach, the plaintiff's conduct is analyzed in view of the particular fact situation to determine whether his reliance on the

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[21]White v. Abrams, 495 F.2d 724, 736 (9th Cir. 1974).

[22]*See* SEC v. Dolnick, 501 F.2d 1279 (7th Cir. 1974); Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969). *But see* SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975).

[23]SEC v. Dolnick, 501 F.2d 1279, 1283 (7th Cir. 1974).

[24]The flexible duty standard has been roundly criticized. In Haimoff, *Holmes Looks at Hochfelder and 10b-5*, 32 Bus. Law. 147 (1976), the author accurately characterized the flexible duty standard as "hopelessly indefinable." *Id.* at 147.

[25]Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); City Nat'l Bank v. Vanderboom, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); Rogen v. Ilikon Corp., 361 F.2d 260 (1st Cir. 1966).

defendant's misrepresentations or omissions was justified.[26] In *City National Bank v. Vanderboom*,[27] an Eighth Circuit Court of Appeals decision, a consortium of investors obtained an option to purchase a corporation. The corporation owned a financial institution whose aquisition, the investors believed, would aid their own construction business. During the negotiations, the sellers misreresented the financial condition of the companies and a bank with actual knowledge of the shaky financial condition of the companies loaned the investors the money to acquire the corporation. For the four month duration of the option, the investors had access to the corporation books and records but never investigated. The bank later filed suit on the investor's outstanding notes, and the investors counterclaimed under rule 10b-5, alleging that the bank failed to reveal the actual financial condition of the companies. The court dismissed the counterclaim, because a reasonable investigation would have provided the investors with the omitted information.[28] The court developed a test by which the plaintiff's reasonable reliance could be determined: Where there is misrepresentation, reasonable reliance is conditioned upon the plaintiff's exercise of due care in light of the particular circumstances existing at the time the misrepresentation is made. In the non-disclosure situation, reasonable reliance is also dependent upon an exercise of due care, but in addition, the plaintiff must also demonstrate that he is entitled to receive a full disclosure and that he would have acted differently had the alleged omission not occurred.[29] The *Vanderboom* court held that reliance could not be justified unless there had been some investigation by the plaintiff.[30] Thus, *Vanderboom* imposed a positive duty of reasonable investigation on the plaintiff prior to recovery.[31]

The reliance approach is logical in that the plaintiff must investigate the prospective transaction, and the approach is flexible enough to correlate with the particular fact situation. However, the validity of a link between due care and reliance is in jeopardy and has been questioned in the Supreme Court's decision in *Affiliated Ute Citizens v. United States*.[32] In *Affiliated Ute Citizens*, a bank purchased securities from a group of Ute Indians who were un-

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[26]545 F.2d at 697.

[27]422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970).

[28]*Id.* at 230-31.

[29]*Id.* at 230. The test also provides that once the court is satisfied that the plaintiff has discharged his duty of due diligence, the defendant's conduct must be examined to see whether it was intentional or negligent.

[30]*Id.* at 230-31.

[31]*Id.* at 230 n.10. The court held that the investigation would have to be reasonable under the circumstances of the individual case.

[32]406 U.S. 128, *reh. denied*, 407 U.S. 916, *reh. denied*, 408 U.S. 931 (1972).

familiar with investment practices. Without telling the plaintiffs, the bank sold the securities in an artificially inflated market, which the bank was able to manipulate. The Court of Appeals denied recovery, because the plaintiffs were unable to prove that had the omitted information been revealed, they would not have consented to the sale.[33] The Supreme Court reversed the decision and held: "All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision."[34] In cases prior to *Affiliated Ute Citizens*, the plaintiff was required to prove that the omitted information would have been instrumental in their investment decision. With the multitude of potential factors that can influence an investment decision, *Affiliated Ute Citizens* relieved the plaintiff of an almost impossible burden of proof.[35] The Supreme Court in *Affiliated Ute Citizens* created a distinction between acts of affirmative misrepresentation and omission. If misrepresentation occurs, the plaintiff must still demonstrate his reliance on the defendant's statements, whereas with omissions, proof of reliance is not required. When this distinction is carried through to a due diligence analysis, the plaintiff's burden of due care may be eliminated in omissions cases. If reliance is presumed, once materiality has been demonstrated, the court will no longer be in a position to determine if the reliance is reasonable. Thus, if reliance does not become an issue, any discussion in which reliance and due diligence are linked will also vanish.[36] This misrepresentation/omission distinction is an unwarranted limitation when applied to due diligence. The courts have used the due diligence defense to limit recovery to those plaintiffs who have exercised due care in the marketplace,[37] and this policy is not modified merely because the particular case is based on an omission. If imposing a duty of due care promotes efficiency and fair dealing in the marketplace,[38] it should apply to both omission and misrepresentation cases. If the plaintiff's due diligence can

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[33]Reyos v. United States, 431 F.2d 1337, 1348 (10th Cir. 1970).

[34]406 U.S. at 153-54.

[35]*See, e.g.*, Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); Jackson v. Oppenheim, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (3d Cir. 1976).

[36]Although *Affiliated Ute Citizens* eliminates the proof of reliance, there is some suggestion by the court in Rochez Bros. v. Rhoades, 491 F.2d 402, 410 (3d Cir. 1975), *cert. denied*, 425 U.S. 993 (1976), that the defendant may be able to put reliance in issue for due diligence purposes. While this procedure has never been attempted, it seems probable that since the proof of reliance was eliminated to avoid the complicated analysis and burden of proof problems that accompany reliance in omission cases, the court would be unwilling to resurrect the problems they sought to eliminate.

[37]Dupuy v. Dupuy, 551 F.2d 1005, 1016 (5th Cir.), *cert. denied*, 434 U.S. 411 (1977).

[38]*Id. See also* Straub v. Vaisman & Co., 540 F.2d 591 (3d Cir. 1976).

reveal misrepresentations, it can also turn up material omissions. By imposing a duty of due diligence in both omission and misrepresentation cases, one of the primary policy objectives of rule 10b-5, which is to encourage careful investment conduct by all parties, is furthered.

One court has used materiality in an attempt to define the scope of due diligence.[39] Materiality is generally defined as whether a reasonable investor might consider the fact important to his investment decision.[40] Using materiality to define the scope of due diligence, different levels of due care are imposed to correspond to each investor's level of sophistication. Presumably, a corporate insider could only consider a representation to be material after he has made an extensive investigation. The unsophisticated investor would have a correspondingly lower threshold of materiality for the same information. If a defendant misrepresents or omits information and the plaintiff ascertains the nature of the information, the plaintiff is not permitted to recover, because the facts are no longer material.[41] This reasoning is an extension of the traditional concept of materiality. The question of when an investor *would* be influenced by a fact and when he *should* be influenced by the same fact are far different concepts. A plaintiff with special expertise might consider information important to his investment decision and thus material, but at the same time he might realize that the information is false. Little is done to promote the policies of rule 10b-5 if investors are allowed to recover when their expertise would indicate that their reliance on the information has been unreasonable.

Several courts, in exercising their equitable discretion, have ruled that a duty of due care should be imposed.[42] Often these courts do not attempt an extended analysis, but simply state their conclusion supported by citation to other cases where a due diligence standard has been imposed.[43] Courts often use wide latitude in exercising their equitable discretion; such as in *Kohler v. Kohler Co.*,[44] where the court imposed a due care burden on both parties. In *Kohler*, the plaintiff sold common stock to the corporation for less than the true market value and then brought suit alleging that he

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[39]Taylor v. Smith, Barney & Co., 358 F. Supp. 892 (D. Utah 1973).

[40]SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 404 U.S. 1004 (1971); List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811, *reh. denied*, 382 U.S. 933 (1965).

[41]Straub v. Vaisman & Co., 540 F.2d 591, 596 (3d Cir. 1976).

[42]*See, e.g.*, Frigitemp Corp. v. Financial Dynamics Fund, 524 F.2d 275 (2d Cir. 1975); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); Kaplan v. Vornado, 341 F. Supp. 212 (N.D. Ill. 1971).

[43]*See* Wheeler, *supra* note 6, at 588.

[44]319 F.2d 634 (7th Cir. 1963).

was induced to sell the stock by the misrepresentations, half truths, and omissions of the defendant. The plaintiff sued under rule 10b-5, contending that the defendant's conduct breached the corporate insider's duty to fully and accurately disclose all facts pertaining to the value of the stock.[45] Even though the plaintiff accused the defendant of violating his insider duties, both parties could probably have been classified as insiders.[46] The *Kohler* court discussed the duty of insiders to disclose material information and framed the disclosure requirement in terms of a flexible duty:

> On one hand, the corporate insiders must scrupulously disclose to outsiders those material facts about a corporation's business which in reasonable and objective contemplation might affect the value of the corporation's stock or securities and which insiders should reasonably believe are unknown to the outsider. On the other hand they are not required to search out details that presumably would not influence the person's judgment with whom they are dealing.[47]

The court was prompted by an overriding concern to promote an equitable result between the parties and thus held that where the plaintiff had the means available to discover the information and made no effort to do so, he could not recover.[48]

A final approach has been to characterize due diligence as a separate element of the rule 10b-5 action. In *Clement A. Evans & Co. v. McAlpine*,[49] the defendant was able to create an appearance of financial solvency by obtaining bank loans with non-existent securities pledged as collateral. Under this guise, the defendant was able to trade large amounts of securities with the plaintiff and paid for the purchased securities with checks drawn on his personal account. Throughout the four months of trading, several of the defendant's checks were dishonored for insufficient funds. Despite the earlier bad checks, the plaintiff continued to trade securities with the defendant. This procedure was contrary to accepted industry practice and was also prohibited under federal guidelines, which require a customer's account to be frozen for ninety days when irregularities appear.[50] The plaintiff instituted suit under rule 10b-5 to

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[45]*Id.* at 636.

[46]The plaintiff owned 21,415 shares of the 200,000 outstanding shares of Kohler Co. stock, had been employed by the corporation for 22 years, had been a director of the company for 11 years, and had been an officer (secretary) for another 10 years.

[47]319 F.2d at 642.

[48]*Id.* at 641.

[49]434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971), *reh. denied*, 404 U.S. 874 (1971).

[50]Federal Reserve Board Regulation T, 12 C.F.R. § 220.4(c)(8) (1977), requires that any irregularity in a customer's account be investigated by the brokerage firm. The

recover the proceeds of the last five checks. The Fifth Circuit Court of Appeals affirmed the trial court's decision to deny recovery, because the plaintiff had not exercised due diligence.[51] The court's jury instruction imposed the following duty of due diligence on the plaintiff:

> If you find from the evidence in this case that the plaintiff had knowledge of facts sufficient to excite its inquiry, and the peculiar circumstances of this case were sufficient to impose upon the plaintiff a duty of reasonable diligence, and that the plaintiff failed to exercise this duty, then you should return a verdict for the defendants.[52]

In *McAlpine*, the court separated due diligence from the concepts of variable disclosure or reliance and reasoned that the due diligence issue should be treated in the nature of an affirmative defense.[53] The plaintiff was required to exercise that degree of diligence which was reasonable under the particular facts.[54] The court listed several factors that influenced the level of diligence which is required: Existence of a fiduciary relationship, concealment of the fraud, opportunity to detect the fraud, position in the industry, sophistication and expertise in the financial business community, and knowledge of the related proceedings.[55] These duty conditioning factors are similar to the duty disclosing considerations of the flexible duty standard.[56] However, under the *McAlpine* approach, the defendant must give a full and accurate disclosure of his available information regardless of the sophistication of the plaintiff. This full disclosure requirement is more equitable and compatible with SEC enforcement actions than a variable standard. When due care is treated as an affirmative defense, the due diligence analysis is removed from the defendant's causation, and the defendant's prima facie liability is established before due diligence becomes an issue. This policy promotes flexibility, because the defendant's fraudulent conduct can be punished in an SEC enforcement action,[57]

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brokers are allowed 90 days to investigate the irregularities, and during that time, the customer's trading account is to be frozen.

[51]434 F.2d at 104.

[52]*Id.* at 102.

[53]*Id.* at 104. The court noted the decision in Kuehnert v. Texstar Corp., 412 F.2d 700 (5th Cir. 1969), which held that affirmative defenses, such as *in pari delicto*, are available in rule 10b-5 actions and rest within the sound discretion of the court.

[54]*Id.* at 102-03.

[55]*Id.* at 102.

[56]*See* text accompanying note 18 *supra.*

[57]The court in Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974), recognized the possibility of separate public and private actions where different results could be reached.

but if the plaintiff's conduct also contributed to his injury, he will be denied recovery.

The only remaining aspect of the separate element approach to due diligence is to determine what level of due diligence will be required of the plaintiff. The *McAlpine* court concluded that a negligence standard would best serve the policy interests of rule 10b-5[58] and extended this duty to all aspects of the defendant's conduct. If the plaintiff's investigation was not reasonable, he would be denied recovery regardless of whether there had been misrepresentation or omission, negligent conduct by the defendant, or intentional misconduct.[59] This reasoning is interesting when compared with traditional tort law concepts where contributory negligence is a bar to recovery for a negligent but not an intentional misrepresentation.[60] By allowing a plaintiff's lack of due diligence to bar recovery where the defendant's conduct is intentional, the potential class of plaintiffs in rule 10b-5 actions will be more restricted than in common law deceit actions.

Some support for the *McAlpine* position can be found in *Rochez Bros. v. Rhoades*[61] in which the plaintiff-seller investigated the circumstances surrounding the purchase of his interest by his co-owner, the defendant. Despite a reasonable investigation, the plaintiff did not discover the facts that were intentionally omitted by the defendant.[62] The Third Circuit Court of Appeals required that the plaintiff must "fulfill a duty of due care in seeking to ascertain for himself the facts relevant to a transaction."[63] Under this particular fact situation, the court concluded that the plaintiff discharged his duty, but the court still discussed the due diligence issue notwithstanding the intentional conduct by the defendant.[64] This analysis suggests that the court would hold the duty of due diligence applicable to both intentional and negligent conduct.

In *Mitchell v. Texas Gulf Sulphur Co.*,[65] the court concluded that the defendants made intentional misrepresentations and knowingly omitted material facts.[66] The *Mitchell* court did not allow the plaintiff an unlimited amount of time to rely on the intentional misrepresentations and barred the plaintiff's recovery, because he

[58]434 F.2d at 104.

[59]*Id.*

[60]RESTATEMENT (FIRST) OF TORTS § 540 (1938); W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 108 at 716 (4th ed. 1971).

[61]491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976).

[62]*Id.* at 408 n. 8.

[63]*Id.* at 409.

[64]*Id.* at 407-08.

[65]446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

[66]*Id.* at 102.

could not demonstrate due diligence.[67] Some courts do make the intentional/negligent distinction, and the court in *Carrol v. First National Bank of Lincolnwood*[68] strictly followed the tort analogy. In *Carroll*, a rule 10b-5 claim was based on the defendant-bank's alleged fraudulent conspiracy for failing to make expedient payments and settlements of securities transactions. The delay in settlement enabled other participants in the scheme an opportunity to engage in short term speculation, using the plaintiff's funds. Through a motion to dismiss, the defendant attempted to assert the defense of contributory negligence based upon the plaintiff's careless handling of the securities sales. The court held that the defense of contributory negligence was not available where the complaint was founded on fraud rather than negligence.[69] These cases show the two extremes of the intentional/negligent distinction. Most courts have refused to explicitly discuss the intentional/negligent distinction, and consequently, decisions can often by interpreted as falling somewhere between the two extremes.[70]

The various approaches and standards used to implement the due diligence duty reflect the latitude the courts have used in rule 10b-5 cases. While the different theoretical approaches generally conclude that some duty of due diligence should exist, the recent Supreme Court case of *Ernst & Ernst v. Hochfelder*[71] has prompted a complete re-examination of the due diligence issue.

II. Recent Judicial Development of Due Diligence

The duty of due diligence is premised on reasonable investor conduct. The reasonable conduct concept is, in essence, a negligence standard.[72] Recently courts have started questioning the availability

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[67]*Id.* at 103.

[68]413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970).

[69]*Id.* at 358. The court did not discuss the possible relevancy that a contributory negligence (due diligence) defense could have at trial. The court's narrow holding was that such a defense was not proper when asserted in a motion to dismiss. This court expressed a general unwillingness to accept a due diligence defense in fraud cases especially where the court could find no legislative mandate for such a limitation and the defendant offered no supporting case law.

[70]Before the Supreme Court's decision in Ernst & Ernst v. Hochfelder, 425 U.S. 185, *reh. denied*, 425 U.S. 986 (1976), liability in rule 10b-5 actions could be imposed on the defendant for negligent or intentional conduct. Therefore, there was little reason for courts to specifically decide if the defendant's conduct was, in fact, intentional. Complaints under rule 10b-5 that may have alleged intentional conduct were often decided in favor of liability once the court concluded that the conduct was at least negligent. Any due diligence discussion under these circumstances would not indicate whether the court indeed felt that due diligence and intentional conduct were compatible. *See* text accompanying notes 76-77 *infra* for a discussion of the scienter standard now required in rule 10b-5 cases.

[71]425 U.S. 185, *reh. denied*, 425 U.S. 986 (1976).

[72]*See* note 70 *supra*.

of a negligence based due diligence defense where the defendant's liability cannot be imposed for mere negligence.

In *Hochfelder*, the Supreme Court eliminated the imposition of rule 10b-5 liability based on negligence.[73] The accounting firm of Ernst & Ernst contracted with the First Securities Company of Chicago to audit the firm's books and records. The president of First Securities perpetrated an intentional fraud by converting customers' escrow funds to his own use. In connection with their auditing function, Ernst & Ernst was required to file reports with the Securities and Exchange Commission.[74] The rule 10b-5 charge alleged that Ernst & Ernst aided and abetted the fraud be failing to utilize "appropriate auditing procedures."[75] Ernst & Ernst was charged with negligent conduct, and the plaintiffs conceded that there was no "existence of fraud or intentional misconduct on the part of Ernst & Ernst."[76] The Supreme Court held that the alleged negligent conduct by Ernst & Ernst was insufficient to maintain a rule 10b-5 action and established scienter as the appropriate standard for rule 10b-5 liability.[77] The Supreme Court characterized scienter as a mental state embracing an intent to deceive, manipulate, or defraud.[78] With scienter or intentional conduct now required in rule 10b-5 cases, several jurisdictions have reassessed their due diligence standards.

In *Straub v. Vaisman & Co.*,[79] the Third Circuit Court of Appeals became one of the first courts to reconsider the due diligence issue. The plaintiff, a sophisticated manager of a Eurpoean investment firm, purchased securities from the firm of Vaisman & Co. Vaisman and an employee, Charles Erb, had previous dealings with the plaintiff, and knowing of the plaintiff's desire to purchase a new stock issue, recommended the purchase of Loren Industry's Mark I offset

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[73]425 U.S. at 193.

[74]SEC rule 17a-5, 17 C.F.R. § 240.17a-5 (1975), required that First Securities file annual reports of financial condition together with an accountant's opinion expressing that the reports were prepared under generally accepted auditing standards. Specifically included under "generally accepted auditing standards" is no authority to allow omissions of any procedures that independent accountants would ordinarily employ in the preparation of a similar audit. *Id.*

[75]425 U.S. at 190. The president of First Securities implemented a "mail rule," which provided that under any circumstances only he could open mail addressed to him at the firm. Such a procedure was an irregularity and should have been disclosed. The plaintiffs charged Ernst & Ernst with negligence for never having discovered this procedure. For a complete look at the fraudulent scheme at First Securities, *see* SEC v. First Securities Co., 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972).

[76]425 U.S. at 190.

[77]*Id.* at 193 n.12. The Supreme Court left open the possibility of reckless conduct being sufficient for civil liability under rule 10b-5. *See* text accompanying note 108 *infra*, for an illustration of reckless conduct sufficient to sustain rule 10b-5 liability.

[78]425 U.S. at 190.

[79]540 F.2d 591 (3d Cir. 1976).

stock. Vaisman and Erb told the plaintiff that the new stock issue would be offered at a price of four dollars per share. The purchased stock was not of new issue, and its market value per share was considerably less than four dollars. Vaisman and Erb also had inside information of the precarious financial condition and imminent bankruptcy of Loren, which they never revealed to the plaintiff. The plaintiff sued for relief under rule 10b-5, and the defendants pleaded lack of due diligence as a defense.[80] The *Straub* court first decided to treat due diligence as a separate element of the rule 10b-5 cause of action.[81] The court concluded that the *Hochfelder* decision prompted a change in the standard of due diligence and attempted to analyze due diligence using the common law tort analogy and public policy considerations.[82] The tort law similarity prompted the court to reason "that since intent to defraud is a necessary element of a 10b-5 action, the due care defense should be narrowly circumscribed."[83] The *Straub* court did not treat the tort law similarity as conclusive but instead "balanced the tort concepts with the public policies underlying the federal securities laws."[84] The court identified the applicable public policy as encouraging investor care in the marketplace and promoting an efficient market where fair dealing is encouraged.[85] The court balanced the competing tort concepts and policy considerations and imposed a burden on the plaintiff to act reasonably.[86] Presumably, this standard is somewhere between allowing a due diligence defense based on negligence to bar recovery and treating due care considerations as irrelevant. The *Straub* court held that the duty of due care should be flexible and allowed to vary with the particular circumstances of each case.[87] In a concession to tort law, the court narrowed the availability of the due diligence defense by reversing their previous burden of proof for due care.[88] The plaintiff was relieved of his affirmative duty to plead and prove due diligence, and the burden shifted to the defendant, who was required to raise the lack of due diligence as an affirmative defense and carry the corresponding burden of proof.[89] The flexible duty allows the plaintiff's standard of due diligence to vary with

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[80] *Id.* at 596.

[81] *Id.* at 596-97. This approach is consistent with the earlier Third Circuit opinion in Rochez Bros. v. Rhoades, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976), where the court treated the duty of due care as a distinct element of rule 10b-5.

[82] 540 F.2d at 597.

[83] *Id.*

[84] *Id.*

[85] *Id.* at 598.

[86] *Id.* at 597.

[87] *Id.* at 597-98.

[88] *Id.* at 598.

[89] *Id.*

both the investor's status and the particular fact situation. Thus, a sophisticated investor may not be denied recovery based on a lack of due diligence if the particular circumstances were such that his access advantages were negated.[90] It is unclear exactly what standard is imposed by the *Straub* court. The court rejected a negligence standard[91] yet still required the plaintiff to act reasonably.[92] This subjective approach is somewhat confusing, but it gives the Third Circuit a workable standard by which to assess due diligence. In a typcial case, the defendant would be required to put due diligence in issue, then looking at all the available facts, the defendant would have to prove the plaintiff's conduct was unreasonable. It will be interesting to see how future Third Circuit decisions deal with this reasonableness requirement. The Third Circuit has limited the availability of the due diligence defense but is still willing to impose a duty of due diligence even where the defendant's conduct is clearly intentional.[93]

After the decision in *Straub*, the district court in *McLean v. Alexander*[94] apparently relaxed the availability of the due diligence defense. In *McLean*, the court charged the plaintiff with a duty of due diligence commensurate with his investor sophistication.[95] The court concluded that the scope of the inquiry should be what a similarly situated plaintiff "reasonably could or should have done under the circumstances."[96] The court's use of the "could or should have done" language seemed to suggest a negligence standard.[97]

The Tenth Circuit Court of Appeals drastically reduced the availability of the due diligence defense in *Holdsworth v. Strong*.[98]

[90]*Id. See, e.g.*, Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); Rochez Bros. v. Rhoades, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976); Stier v. Smith, 473 F.2d 1205 (5th Cir. 1973).

[91]540 F.2d at 597. The court rejects the neglience standard that was used in *McAlpine*, because it provides less remedial relief to the trusting investor than does the common law.

[92]*Id.* In deciding whether the plaintiff has acted reasonably, the court considers the following: The existence of a fiduciary relationship, the opportunity to detect the fraud, the sophistication of the plaintiff, the existence of long standing business or personal relationships, and the access to relevant information as all being worthy of discussion.

[93]The court characterized Vaisman's conduct as "wilful, wanton and reprehensible." *Id.* at 595.

[94]420 F. Supp. 1057 (D. Del. 1976).

[95]*Id.* at 1078.

[96]*Id.* at 1079.

[97]*Id.* The negligence standard was rejected in the Third Circuit by the *Straub* court. The *McLeon* court found it difficult to settle on a specific due diligence standard but still concluded that "in that uncharted land of knowing and reckless misconduct, defendant should be entitled to contest liability by asserting a due diligence defense." *Id.* at 1078.

[98]545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977).

There, the plaintiff sold his shares of a closely held corporation to the defendant. The plaintiff was a corporate insider, attorney, and accountant who had complete access to the corporate records and possessed a high degree of business expertise, but because of his trust in the defendant, rarely engaged in any management activities. The defendant intentionally misrepresented the financial condition of the company and indicated that the corporation would be unable to pay any dividends. Based on these misrepresentations, the plaintiff offered to sell his interest to the defendant. After learning the true condition of the corporation, the plaintiff filed suit under rule 10b-5, and the defendant's principal defense was that the plaintiff failed to exercise due diligence.[99] The *Holdsworth* court denied the application of due diligence and held that "where the liability of the defendant requires proof of intentional misconduct, the extraction of a due diligence standard becomes irrational and unrelated."[100] The court placed primary emphasis on the tort law analogy and reasoned that the *Hochfelder* decision brought the standards for rule 10b-5 liability very close to the standards applicable to the tort law offenses of deceit or intentional misrepresentation.[101] The *Holdsworth* court was also concerned that the use of a due diligence defense would unnecessarily limit the availability of the rule 10b-5 remedy. The court went so far as to suggest that if a plaintiff is required to prove that the defendant acted with scienter and at the same time prove that he acted with due diligence, recovery would only be possible in "extraordinary" cases.[102] The court was also concerned that the defendant could use the due diligence defense to shift the focus of blame from his own conduct to an innocent plaintiff and preclude recovery, because "the defendant would likely be able to demonstrate some lack of diligence on the part of the plaintiff."[103] This criticism of the due diligence defense may be unwarranted, because even in its most permissive application, the due diligence defense will only bar recovery for unreasonable conduct. Certainly some lack of due diligence will not bar recovery unless, under the totality of the circumstances, the plaintiff's conduct was unreasonable. The *Holdsworth* decision requires that the plaintiff use justifiable reliance.[104] However, this concept is tied up with notions of materiality and is designed to insure that the defendant's conduct was the proximate cause of the plaintiff's harm;[105] it is not the imposition of a duty of due care. The court concluded that if the

[99] *Id.* at 691.
[100] *Id.* at 692.
[101] *Id.* at 693.
[102] *Id.*
[103] *Id.*
[104] *Id.* at 694.
[105] *Id.* at 698.

plaintiff's conduct is to bar recovery, it should be gross conduct, somewhat comparable to that of the defendant.[106] Carrying through with the tort law standards, the *Holdsworth* case has all but eliminated a distinct due diligence defense in 10b-5 cases.

The Seventh Circuit Court of Appeals in *Sundstand Corp. v. Sun Chemical*[107] followed the *Holdsworth* logic and also limited the use of the due diligence defense. In *Sundstand*, the plaintiff brought a rule 10b-5 claim against the defendant, alleging "intentional or reckless" omissions and misrepresentations.[108] The court recognized that *Hochfelder* permitted a rule 10b-5 claim to be raised on recklessness.[109] The defendant attempted to avoid liability by asserting a lack of due diligence on the part of the plaintiff. The court responded by holding that the due diligence defense is not available in an intentional fraud case.[110] The *Sundstand* court apparently was secure in the *Holdsworth* reasoning and attempted no further independent due diligence analysis. The court also supported the *Holdsworth* reasoning that once reliance is shown based on the misrepresentations, that is sufficient to show a causal connection between the misrepresentations and the defendant's injury.[111] Apparently this is the extent of the plaintiff's duty unless his conduct is as culpable as that of the defendant.[112]

The Fifth Circuit Court of Appeals decided the *Hochfelder* decision was sufficient justification to modify their often-cited opinion in *Clement A. Evans & Co. v. McAlpine.*[113] In *Dupuy v. Dupuy,*[114] the court was faced with the classic insider case, as the parties were both brothers and partners in a joint real estate venture. The plaintiff was originally an active participant in the project but later became disenchanted and offered to sell his interest to his brother. During the subsequent negotiations, the defendant intentionally misrepresented the success prospects of the venture. Relying upon

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[106]*Id.* at 693. Presumably, the due diligence defense would only be available as a *pari delicto* defense where the plaintiff knew the misrepresentation was false and still relied. *In pari delicto* is a common law equitable doctrine that prohibits recovery where a party substantially contributes to his own loss. Generally, the *in pari delicto* defense is given a narrow interpretation and precludes recovery only where the plaintiff's conduct is as culpable as that of the defendant. *See* Tarasi v. Pittsburgh Nat'l Bank, 555 F.2d 1152, 1156-57 (3d Cir. 1977).

[107]553 F.2d 1033 (7th Cir.), *cert. denied*, 98 S.Ct. 225 (1977).

[108]*Id.* at 1039.

[109]*Id.* at 1039-40. *See, e.g.*, Sanders v. John Nuveen & Co., Inc., 554 F.2d 790 (7th Cir. 1977); Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F.2d 27 (2d Cir. 1976).

[110]553 F.2d at 1040.

[111]*Id.*

[112]*Id.* at 1048 (quoting Holdsworth v. Strong, 545 F.2d at 693).

[113]434 F.2d 100 (5th Cir.), *cert. denied*, 402 U.S. 988 (1970).

[114]551 F.2d 1005 (5th Cir.), *cert. denied*, 98 S.Ct. 312 (1977).

these misrepresentations, the plaintiff sold his interest to the defendant at a shockingly low price.[115] The plaintiff sued for damages under rule 10b-5, and the defendant denied liability partially based on the plaintiff's failure to exercise due care.[116]

The trial court jury followed the *McAlpine* procedure and examined the due diligence issue as a separate element in rule 10b-5 and concluded that the plaintiff had exercised due diligence. The trial judge granted the defendant's motion for a judgment notwithstanding the verdict and held that there was no evidence of due care on the part of the plaintiff.[117] The Fifth Circuit Court of Appeals overturned the trial court and examined the due diligence issue. The court first discussed how the due diligence analysis was to be structured. The court affirmed the methodology of keeping the due diligence issue as a separate element in rule 10b-5 cases.[118] The court identified the policy that a due diligence requirement promoted the general equitable principle that only those who have pursued their own interests in good faith should qualify for a rule 10b-5 remedy.[119] The court also reasoned that to require plaintiffs to exercise due care in the investment market promotes the anti-fraud policies of rule 10b-5.[120] The due diligence approach was to be judged subjectively,[121] and the duty was also to be imposed on the basis of particular plaintiff's attributes rather than conditioning the duty on the abilities of the reasonable investor.[122] The court noted that the *McAlpine* reasonableness/negligence standard was set out prior to the *Hochfelder* decision, and concluded that the new standard for due diligence imposed on the plaintiff should be no more rigorous than that which is imposed on the rule 10b-5 defendant.[123] Since recklessness is the minimum level of culpability that imposes liability on a rule 10b-5 defendant, the due diligence standard should also be conditioned on recklessness.

Under this post-*Hochfelder* due diligence framework, the plaintiff's conduct must be examined to determine whether he "intentionally refused to investigate in disregard of a risk known to him or

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[115]The plaintiff sold his interest for $10,000 and the court awarded damages based on an appraised value of his interest of $905,000.

[116]*Id.* at 1007.

[117]*Id.*

[118]*Id.* at 1014.

[119]*Id. See, e.g.*, Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 104 (5th Cir.), *cert. denied*, 402 U.S. 988 (1970); City Nat'l Bank v. Vanderboom, 422 F.2d 221, 230 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970).

[120]551 F.2d at 1016.

[121]*Id.*; Straub v. Vaisman & Co., 540 F.2d 591, 598 (3d Cir. 1976); Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 102 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1970).

[122]551 F.2d at 1014.

[123]*Id.* at 1020.

so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow."[124] This standard falls between the reasonable standard imposed in *Straub v. Vaisman*[125] and the strict limitation which was imposed in *Holdsworth v. Strong*.[126] The *Dupuy* court discussed the tort analogy and noticed the similarities between the policies underlying the common law and the policies applicable to rule 10b-5. Tort law seeks to prevent intentional misconduct and rule 10b-5 specifically seeks to deter manipulative and deceptive practices in the securities market.[127] The lack of legislative history on the policy of promoting investor care is used by the court to conclude that the policy to deter fraudulent conduct is paramount.[128] This reasoning is not conclusive, because rule 10b-5 was enacted as an enforcement procedure[129] and thus the bulk of legislative discussion would naturally be centered on that topic. In addition, under the *Dupuy* approach, a defendant could be liable under an SEC enforcement proceeding and still not be subject to civil liability. The policy of deterring fraudulent conduct does not exclude the policy of promoting investor care because of the unique two step availability of both public and private applications of rule 10b-5. The *Dupuy* court also concluded that the need for further limiting of the rule 10b-5 remedy after *Hochfelder* is questionable.[130] As a final argument, the court reasoned that the history of rule 10b-5 cases is consistent with the distinction between negligent and intentional misrepresentations.[131] This argument is not persuasive when viewed with the early rule 10b-5 cases.[132] The *Dupuy* standard of due diligence represents a compromise between tort law analysis and the public policies underlying rule 10b-5. This compromise limits the availability of the due diligence defense but still holds plaintiffs accountable for their conduct when they have acted recklessly.

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[124]*Id.* (quoting W. PROSSER, HANDBOOK OF THE LAW OF TORTS, § 34 at 185 (4th ed. 1971)).

[125]540 F.2d 591 (3d Cir. 1976) (reasonableness standard used).

[126]545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977) (gross or intentional standard used).

[127]551 F.2d at 1019; Ernst & Ernst v. Hochfelder, 425 U.S. at 206.

[128]551 F.2d at 1019.

[129]*Id.* at 1013; Rochez Bros., Inc. v. Rhoades, 491 F.2d 402, 406 (3d Cir. 1973), *cert. denied*, 425 U.S. 993 (1976).

[130]551 F.2d at 1019.

[131]*Id.*

[132]The only two cases that specifically recognize the distinction are Carroll v. First Nat'l Bank, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970), and Fershtman v. Schectman, 450 F.2d 1357 (2d Cir. 1971), *cert. denied*, 405 U.S. 1066 (1972) (recognized that common law limits would probably apply to rule 10b-5). *See* text accompanying notes 58-67 *supra* for a discussion of cases that do not make the negligent/intentional distinction.

The Second Circuit has not been compelled to follow the lead of the other circuits in limiting the due diligence defense. The court in *Hirsch v. du Pont*[133] was concerned that the elimination of the due diligence defense would allow rule 10b-5 to become an insurance policy for defrauded investors. In *Hirsch*, the plaintiffs were engaged in a series of complex negotiations that eventually led to the merger of the brokerage house of Hirsch & Co. with F.I. du Pont. During these merger discussions, F.I. du Pont was already in serious financial trouble.[134] A surprise audit by du Pont's accountants revealed that du Pont had not complied with the net capital rule[135] that was required by the New York Stock Exchange.[136] This distressing financial information was available from public records of the SEC. The plaintiffs charged that the accountants and the New York Stock Exchange had violated rule 10b-5 by not revealing this information. The court found no liability, holding that there was no duty to

[133]553 F.2d 750 (2d Cir. 1977).

[134]In the late 1960's and early 1970's, many brokerage houses experienced some degree of financial difficulty. The tremendous trading of securities in the mid-1960's bull market created a large backlog of paperwork and many improperly recorded transactions. Many brokerage houses found themselves with large short and long security count differences. Against this disorganized framework, the market began a steady decline in 1969, which caused large losses and subsequent withdrawals of capital. As brokerage houses found themselves unable to cover their short term capital requirements, they often attempted to merge with other brokerage houses to provide a new influx of capital. *See Study of the Securities Industry Crisis in the Securities Industry, A Chronology - 1967-1970* (N.Y.S.E. Report), *reprinted in Hearings before the Subcomm. on Commerce and Finance*, 92d. Cong., 1st Sess. 14 (1971).

[135]The "net capital rule," 17 C.F.R. § 240.15c3-1(a) (1976), was designed to insure brokers and dealers maintained a sufficient amount of liquid assets to protect customers' accounts. This is accomplished by requiring the broker's aggregate indebtedness not to exceed 2,000% of net capital. Aggregate indebtedness is the broker's total monetary liabilities adjusted for any liabilities specifically excluded. Net capital is the net worth adjusted downward by subtracting out those fixed liabilities that cannot become an immediate charge on capital. *Id.* at § 240.15c3-1(c)(2). By complying with the "net capital rule," a broker should have sufficient liquid assets to meet any short term charges on capital. *See Guy D. Marianette*, 11 S.E.C. 967 (1942). For a complete discussion of the net capital rules, *see* Wolfson and Guttman, *The Net Capital Rules for Brokers and Dealers*, 24 STAN. L. REV. 603 (1972).

[136]553 F.2d at 754. On September 28, 1969, the accountant's audit of F.I. du Pont indicated that the ratio of aggregate indebtedness to net capital was over 3,000%, which represented a capital deficiency of approximately $6,800,000. Du Pont also had short count differences of $7,000,000 and long count differences of $30,000,000. *Id.* Securities count differences often occur from the improper recording of securities transactions, which then causes a discrepancy between the actual physical inventory of securities and the records. A short count difference occurs where the broker is unable to locate securities that are recorded as belonging to a customer. Where there are securities on hand whose owners cannot be determined, a long count difference occurs. The short count differences represent a potential immediate charge on capital. *Id.* at 754 n.5.

disclose the information and that the information was available to the plaintiffs "upon the exercise of due diligence to procure it."[137]

The *Hirsch* court placed more weight on the policy of promoting investor care and concluded that an imposition of a negligence based due diligence standard was justified: "The securities laws were not enacted to protect sophisticated businessmen from their own errors in judgment. Such investors must, if they wish to recover under federal law, investigate the information available to them with the care and prudence expected from people blessed with full access to information."[138]

The Second Circuit accepts a negligence based duty of due diligence and is not persuaded by the decisions in the other circuits. In *NBI Mortgage Investment Corp. v. Chemical Bank*,[139] the court acknowledged other decisions that have limited due diligence, but reaffirmed the Second Circuit's position: "Despite the Tenth Circuit's decision in *Holdsworth v. Strong*, a post-*Hochfelder* decision, the standard of due diligence is still viable and accepted in this circuit."[140]

The district court in *Holmes v. Bateson*[141] declined to adopt a specified due diligence standard, concluding that the plaintiff's conduct satisfied both the due diligence standard used in *Dupuy* and the justifiable reliance approach that was used in *Rogen v. Ilikon Corp.*,[142] a 1966 vintage case.[143]

III. Justifications for Due Diligence

Before an attempt can be made to define a workable standard for due diligence in post-*Hochfelder* cases, it must be determined to what extent the common law tort distinction between negligent and intentional conduct is applicable to rule 10b-5. If the common law tort analogy is to be given conclusive weight, it is apparent that the due diligence defense must be severely restrained or even eliminated.

The common law has developed a formidable rule that the carelessness of the injured plaintiff is not a defense to the intentional conduct of the defendant.[144] The common law has retained this position of distinction despite some calls for relaxation of the hard

[137] *Id.* at 753.

[138] *Id.* at 763.

[139] [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,066 (S.D.N.Y. 1977).

[140] *Id.*

[141] [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,228 (D.R.I. 1977).

[142] 361 F.2d 260 (1st Cir. 1966).

[143] [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,228 (D.R.I. 1977).

[144] Restatement (First) of Torts § 540 (1930).

and fast rule.[145] While common law analogies are useful in defining the scope of rule 10b-5, they are not determinative.[146] Some courts have expressly rejected the notion that any one aspect of common law fraud controls recovery under rule 10b-5.[147] Although the common law tort of deceit and rule 10b-5 actions do have some similarities, they definitely do not accomplish the same objectives. Rule 10b-5 has two components: Deterrence of fraudulent conduct through SEC enforcement proceedings, and the compensation of defrauded plaintiffs through the private action.[148] Thus, the SEC specifically precludes the plaintiff from recovering punitive damages in rule 10b-5 cases,[149] while at common law, an intentional misrepresentation may give rise to the recovery of punitive damages.[150] The Supreme Court has held that the implied private actions under federal securities laws seek to compensate victims of stock fraud and thereby promote the public objectives of the act.[151] In rule 10b-5 cases, the existence of the private remedy is explicitly tied into the promotion of the applicable rule 10b-5 policies. As previously discussed, one of the principal policies of rule 10b-5 is to promote investor care and thus encourage stability in the marketplace.[152] The imposition of a due diligence defense is one of the best ways to promote investor care in the marketplace. The defendant is constrained by the enforcement potential of rule 10b-5, and the plaintiff realizes he must exercise due diligence if he is ever to be in a position to be compensated under rule 10b-5. If the common law distinction is allowed to remain, the defendant's conduct is constrained while the plaintiff has no such limitation. More importantly, if the common law distinction is given controlling significance, rule 10b-5 will become analogous to the tort of deceit. Thus, the judiciary will have created a statutory federal common law cause of action with all the advantages of nationwide service

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[145]RESTATEMENT (SECOND) OF TORTS § 540, (Tent. Draft no. 11, 1965), called for a rule that precluded recovery in the intentional misrepresentation case where the plaintiff has either knowledge of the facts or has reason to know of facts that would make his reliance unreasonable. This change was rejected in 42 ALI PROCEEDINGS 331 (1965).

[146]Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, *reh. denied*, 423 U.S. 884 (1975).

[147]White v. Abrams, 495 F.2d 724 (9th Cir. 1974); Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971); Carroll v. First Nat'l Bank, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970).

[148]J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

[149]The Securities and Exchange Act, 15 U.S.C. § 78(b) (1970), limits the amount recoverable to actual damages.

[150]W. PROSSER, HANDBOOK OF THE LAW OF TORTS, § 110, at 736 (4th ed. 1971).

[151]J.I. Case Co. v. Borak, 377 U.S. 426, 432-35 (1963).

[152]Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); Straub v. Vaisman & Co., 540 F.2d 591 (3d Cir. 1976).

and relaxed federal rules of evidence. If the federal standards of recovery and the common law standards of recovery were to be identical, there appears to be no need to imply the broad federal remedy.

The tort law distinction does not seem so compelling when the compensation of the plaintiff is linked to the public objectives of the federal securities laws. When the tort law is balanced with the public policy considerations, a duty of due care seems justified.

The private right to recover under rule 10b-5 is conditioned on judicial decisions, and thus, the courts should not be hesitant in also defining the limits of permissible recovery. The Supreme Court has said that it is dealing with "a private cause of action [under rule 10b-5] which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question."[153] Courts are free to condition recovery in any manner they wish. Turning to the most basic principle, equity would favor the imposition of a duty of due diligence. The equitable maxim that one must do equity to get equity suggests that we should not permit recovery to a plaintiff whose own conduct has contributed to his injury. The next logical place to look for sources of implied defenses is in the policy objectives behind the legislation. As discussed previously, rule 10b-5 has a two-fold aspect in that it seeks to deter fraudulent conduct and to promote investor care in the marketplace. The SEC enforcement proceeding takes care of the fraudulent conduct, and the requirement of a duty of due care will be the most practical method to insure that all investors are governed by some code of conduct. What must be emphasized is that the imposition of a due diligence duty will not burden the prudent investor. The reasonable investor transacts his business in a way that would never preclude his recovery under rule 10b-5; it was the prudent investor that Congress sought to protect from the manipulative and deceptive practices that are actionable under rule 10b-5.[154] One common objection to the establishment of a due diligence defense is that it would limit the number of plaintiffs entitled to recover under rule 10b-5. One court perceived that the due diligence defense would lead to rule 10b-5 recovery only in extraordinary cases,[155] making the unwarranted assumption that the majority of investors are unreasonable. Under any standard, the reasonable investor will never by prevented from recovering by the due diligence

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[153]Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 749, *reh. denied*, 423 U.S. 884 (1975).

[154]Wheeler, *supra* note 6, at 587.

[155]*See* Straub v. Vaisman & Co., 540 F.2d 591 (3d Cir. 1976) discussed in text accompanying notes 79-93 *supra*.

defense. Thus, in a restrictive due diligence framework, a fraudulent defendant could not escape rule 10b-5 liability if a plaintiff was merely negligent, and the supplemental enforcement effect of a private rule 10b-5 remedy would remain viable.[156]

Although rule 10b-5 was enacted as an enforcement procedure and thus does not speak of a policy of due diligence,[157] the Supreme Court has noted that section 10b must be read flexibly and not restrictively.[158] In some private remedies under securities laws, Congress has explicitly defined what conduct by the plaintiff will bar recovery.[159] Section 10b has no such limitation, and in some activities the SEC has often impliedly required an exercise of due care to maintain an acceptable level of conduct and help insure the efficiency of the immense securities marketplace.[160] Finally, if a duty of due care is not imposed, a whole range of conduct which may technically not exclude recovery under rule 10b-5, but which obviously has no place in the securities market, will not be deterred.

The Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*[161] has noted that policy considerations are to be given a good deal of weight in rule 10b-5 cases.[162] With the tort policies not clearly demanding a serious restriction on the availability of a due diligence defense and policy factors weighing heavily in favor of due diligence, it seems reasonable to conclude that some form of due diligence should be required. However, given the impact of the *Hochfelder* decision, the due diligence defense must move beyond a simple negligence standard. The Supreme Court has stated that one of the most important purposes of federal securities laws is to "substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus achieve a high standard of business ethics in the securities industry."[163] Retaining a restrictive due diligence defense is consistent with this objective.

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[156]The implied private remedy under rule 10b-5 was created to compensate victims and not punish the violators. *See* Herpich v. Wallace, 430 F.2d 792, 804 (5th Cir. 1970). However, the deterrent or *in terrorem* effect of a private rule 10b-5 remedy has long been recognized. *See* Globus v. Law Research Service Inc., 418 F.2d 1276, 1288 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). Thus, the private rule 10b-5 remedy serves as a necessary supplement to SEC enforcement proceedings. 430 F.2d at 804.

[157]Freeman, *Administrative Procedures*, 22 Bus. Law. 891, 922 (1967).

[158]Superintendant of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).

[159]*See, e.g.*, Securities and Exchange Act of 1934, § 18(a), 15 U.S.C. § 78r (1976); Securities Act of 1933, § 11(a), 15 U.S.C. § 77k (1976), which will deny recovery to a plaintiff who had actual knowledge.

[160]Securities and Exchange Commission Rule 10a-2, 17 C.F.R. § 240, 10a-2 (1977) (due diligence in covering purchases); Securities and Exchange Commission Rule 15b10-9, 17 C.F.R. § 240.15b10-9 (1977) (due diligence required in maintaining broker-dealer distinction in traded securities).

[161]421 U.S. 723 (1975).

[162]*Id.* at 737.

[163]SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963).

IV. A Workable Due Diligence Application

Once it is accepted that some form of due diligence should be retained, it is necessary to identify a rational standard that can be applied to the diverse fact situations commonly found in rule 10b-5 cases. Consideration has been given to the basic theories courts have used in justifying the imposition of a due diligence defense and found most unsatisfactory. The only workable solution is to treat due diligence as a separate element of the rule 10b-5 cause of action.

The first step in the due diligence analysis is to decide in what manner the standard is to be imposed. This is best accomplished through the use of a two-step process. The first step is to classify the investor according to his particular level of sophistication; thus, it becomes possible to determine the minimum level of due care that will be required. This minimum level of investigation is essential to the due diligence analysis. Investors can best be grouped as corporate insiders, professional investors, sophisticated investors, and unsophisticated investors.

A. *The Corporate Insider*

Logically, the corporate insider should be held to the highest minimum level of due care. The court in *Myzel v. Fields*[164] held that an individual's corporate status could classify him as an insider as a matter of law.[165] However, in general, a corporate insider has special access to information that dictates a greater degree of care.[166] The corporate insider has generally been held accountable for what could be ascertained from the corporate books and records,[167] what transpired at corporate meetings,[168] and any other specific information that was made available because of his insider status.[169] The corporate insider should also demonstrate a familiarity with the workings of the company and a higher degree of business expertise.[170] Finally, the corporate insider must use extreme care when he deals with other individuals of a lesser level of expertise.[171] These criteria

[164]386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968). The court in Harnett v. Ryan Homes, 496 F.2d 832 (3d Cir. 1974), went so far as to hold that insiders could not recover from each other.

[165]386 F.2d at 718. *See also* Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963).

[166]Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963); Jackson v. Oppenheim, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (2d Cir. 1976).

[167]Niedermeyer v. Niedermeyer, [1973 Transfer Binder] Fed. Sec. L. Rep. ¶ 94,123, at 501 (D. Ore. 1973).

[168]Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

[169]Hirsch v. du Pont, 553 F.2d 750 (2d Cir. 1977).

[170]Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963).

[171]Jackson v. Oppenheim, 411 F. Supp. 659 (S.D.N.Y. 1974), *aff'd on other grounds*, 533 F.2d 826 (2d Cir. 1976).

are useful in establishing the minimum level of care that should be exercised by insiders, but the corporate insider will not automatically be denied recovery where his conduct does not meet this level of care. If there are particular circumstances that diminish the corporate insider's effective access to information, he will not be held accountable. However, when there are no mitigating circumstances the insider should be held to this minimal level of diligence.

B. The Professional Investor

The professional investor can be defined as an individual whose frequent market participation gives him significant knowledge and financial expertise. Professional investors may be stock brokers and other investors who have large portfolios and thus are heavy traders. The professional investor should be held responsible for all published company financial data.[172] A professional investor should also be denied recovery where he "recklessly enters a speculative transaction"[173] or where he disregards accepted business practices.[174] He should have a good working knowledge of the operation of the securities markets[175] and a reasonable knowledge of business and financial matters in general. The court in *Vors v. Dickenson*[176] held that a plaintiff, whose status was that of a professional investor,[177] had discharged her duty of due care by gathering available financial data and discussing the general financial condition of the company with insiders.[178] However, the professional investor should not be held responsible for knowledge that is possessed by insiders, is not revealed, and is not readily ascertainable, or for information that is supplied by insiders that cannot be independently verified with reasonable effort.[179]

C. The Sophisticated Investor

A sophisticated investor can be classified as having some investment experience and an above average knowledge of financial and business matters. The sophisticated investor should also com-

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[172]Lane v. Midwest Bancshares Corp., 337 F. Supp. 1200, 1210 (E.D. Ark. 1972).

[173]Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir.), *cert. denied*, 402 U.S. 988 (1970).

[174]*Id.*

[175]495 F.2d 607 (5th Cir. 1974).

[176]The plaintiff bought stock in a company where she was employed as an engineer; she had previous banking experience and actively traded a personal stock portfolio with a market value in excess of $200,000.

[177]495 F.2d at 623.

[178]Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d 989 (5th Cir. 1969).

[179]McCormick v. Esposito, 500 F.2d 620 (5th Cir. 1974), *cert. denied*, 420 U.S. 912 (1975); Gordon v. du Pont Glore Forgan Inc., 487 F.2d 1260 (5th Cir. 1973), *cert. denied*, 417 U.S. 946 (1974).

prehend routine investment procedures and be aware of routinely available information. An investor with experience should be knowledgeable in the operation of declarations of dividends and margin requirements and thus should not be permitted to recover on a claimed lack of knowledge of these procedures.[180] A sophisticated investor has also been held responsible for the terms of a redeemable convertible debenture.[181] A sophisticated investor should be able to attach significance to corporate records and public disclosures and act accordingly.[182]

D. *The Unsophisticated Investor*

Even the unsophisticated investor has a minimum level of due care; however, the duty will be conditioned more heavily on the specific information available rather than the reasonableness or diligence of his conduct. Where information is easily obtainable and the plaintiff knows of its existence, he must act to discover the information.[183] For example, an unsophisticated investor should be able to attach significance to an article that describes the shaky financial condition of a company.[184] While the unsophisticated investor has no special expertise, any individual investing in the stock market should be able to read newspaper price quotations and follow price fluctuations.[185]

The second step in determining the level of care is to scrutinize the particular circumstances that are present. Rarely will an investor fit into one of the neat categories outlined above, but rather, the specific facts dictate elevating or reducing the minimum level of due care. Depending on the significance of the particular facts, the standard of the duty of due care may be altered completely. Some factors that have been considered important are: Special trading expertise,[186] inducement by the defendant to enter the transaction,[187] existence of a fiduciary relationship,[188] concealment of the fraud,[189]

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[180] Hafner v. Forest Laboratories, Inc., 345 F.2d 167 (2d Cir. 1965).

[181] Kaplan v. Vornado, Inc., 341 F. Supp. 212 (N.D. Ill. 1971).

[182] Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

[183] Arber v. Essex Wire Co., 490 F.2d 414 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974).

[184] Phillips v. Reynolds & Co., 294 F. Supp. 1249 (E.D. Pa. 1969).

[185] *See, e.g.*, Hupp v. Gray, 500 F.2d 993 (7th Cir. 1974); Hafner v. Forest Laboratories, Inc., 345 F.2d 167 (2d Cir. 1965); Ferland v. Orange Groves of Florida, Inc., 377 F. Supp. 690 (M.D. Fla. 1974).

[186] Fey v. Walston & Co., 493 F.2d 1036 (7th Cir. 1974).

[187] White v. Abrams, 495 F.2d 724 (9th Cir. 1974); Hafner v. Forest Laboratories, Inc., 345 F.2d 167 (2d Cir. 1965).

[188] Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); Rogen v. Ilikon Corp., 361 F.2d 260 (1st Cir. 1966).

[189] Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

opportunity to detect the fraud[190] and general sophistication and expertise in the financial community.[191]

To illustrate the importance that the particular factors often involve, consider the situation of a corporate insider who relies on the trust of a fiduciary relationship and lacks any opportunity to detect the fraud. The insider should not be held to have violated the duty of due diligence despite his level of sophistication.[192]

With intentional conduct now being required of the defendant to generate rule 10b-5 liability, the particular fact situations are often such that the defendant's conduct has vitiated the plaintiff's opportunity to exercise due diligence. If the court focuses on the particular fact situations, it will limit the availability of the due diligence defense, but the clearly unreasonable plaintiff will be denied recovery. This limitation will bring the due diligence defense in closer harmony with the tort rationale, yet a clear and workable standard of due diligence will survive. Such an approach will give the plaintiff the benefit of the defendant's intentional conduct and still promote general equitable principles, which suggest that the plainitff should act reasonably.

V. Conclusion

The different judicial treatments of due diligence point up the need for uniform standards in this area. The present conflict among the circuits on the applicability of the due diligence defense will cause uncertainty and inefficiency in the investment market. The problem has become more acute as a result of the divergence between the Tenth, Seventh, and Second Circuits. The Fifth and Third Circuits fall somewhere between the two extremes, with the other Circuits remaining free to follow the other circuits or to develop their own standards.

The Supreme Court has recently declined to resolve the issue and denied certiorari in *Dupuy v. Dupuy*.[193] Justice White dissented from the denial of certiorari and outlined some of the conflicts that exist among the circuits. He indicated that securities litigation can be complex and expensive; consequently, there is a need for clarification of the ground rules.[194] This is but one of the reasons why the Supreme Court should resolve this conflict. Perhaps as im-

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[190]Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); Straub v. Vaisman & Co., 540 F.2d 591 (3d Cir. 1976); Rochez Bros. v. Rhoades, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976).

[191]Bird v. Verry, 497 F.2d 112 (5th Cir. 1974).

[192]Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977).

[193]Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir.), *cert. denied*, 434 U.S. 411 (1977).

[194]434 U.S. at 411-12.

portant is the fact that in order for the securities market to run efficiently, there must exist an identifiable code of conduct. If the judiciary is going to imply a private remedy under rule 10b-5, the standards should be clearly enumerated. The availability of a due diligence defense will often determine the outcome of a rule 10b-5 action, and this prospect of success should not be contingent upon the particular circuit in which the law suit is filed.

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